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TAX SHELTER INVESTMENTS

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

This pamphlet presents background information regarding tax shelter areas. The areas discussed in the pamphlet include real estate, farming, oil and gas, movie films, equipment leasing, professional sports franchises. The pamphlet also includes a discussion of the use of limited partnerships as well as the tax aspects of the partnership provisions.

Initially, the pamphlet provides a general overview of tax shelters indicating the elements of a tax sheltered investment, the use of limited partnerships, a summary of tax sheltered investments and their related tax deductions, a summary of the provisions in the Tax Reform Act of 1969 affecting tax shelters, the public syndication of tax shelter investments, and the current positions of the Internal Revenue Service and the Securities and Exchange Commission with regard to related aspects of tax shelter investments.

The pamphlet then provides a discussion of each of the areas setting forth a description of the shelter including, in most cases, an example of an investment in the area, then a discussion of present law, followed by a brief analysis of several of the issues which are argued for and against the tax provisions.

Finally, the pamphlet provides a brief description of the provisions in the House-passed bill (H.R. 10612) dealing with tax shelters. One or more pamphlets discussing alternative proposals for dealing with tax shelters and related matters, will be issued subsequently.

1. OVERVIEW OF TAX SHELTERS

General

Over the last several years, there has been a great deal of concern about high income individuals who are able to eliminate or substantially reduce their tax liability through the use of various tax preferences. Congress reviewed this problem in 1969, and the Tax Reform Act of that year contained many provisions to deal with these preferences, either directly or indirectly. Also, the Congress enacted a minimum tax which was intended to cover those situations where Congress believed a tax preference should be allowed, to serve as an incentive for particular kinds of investment, but also believed that it was not desirable to allow taxpayers to cumulate those preferences to such an extent that the taxpayer might escape tax altogether.

Since 1969, however, there has been a substantial growth in the promotion of investments which are advertised as "tax shelters." Although these take a great variety of forms, in general, they all allow taxpayers to offset certain losses not only against the income from those investments but also against the taxpayer's other income, usually from his regular business or professional activity. A major purpose of these investments for most taxpayers is to generate net losses in the initial years of the investment and thereby permit investors to reduce the tax liability on their regular income.

There are several elements that make up a tax shelter investment (though not all of these elements are found in all shelters). The first is the "deferral" concept where deductions are accelerated in order to reduce the tax liability of an individual in the early years of the transaction instead of matching the deductions against the income which is eventually generated from the investment. This deferral of tax liability from earlier years to future years can be viewed as an interest-free loan by the Federal Government, repayable when, and as, the investment either produces net taxable income, is sold or is otherwise disposed of.

The second element of a tax shelter is "leverage" whereby a taxpayer maximizes his tax benefits, as well as his economic situation, by using borrowed funds in his investments to pay the expenses for which accelerated deductions are received. The individual's position is enhanced when the borrowing is on a nonrecourse basis, which means that he is not personally liable to repay the loan, but his personal investment risk is limited to his equity investment. Limited partnerships generally are used in tax shelter investments so that the taxpayer can invest as a limited partner with no liability other than the amount of equity that he has advanced from his own funds.

In addition, a third tax shelter element for many investments is "conversion" of ordinary income to capital gains at the time of a subsequent sale or other disposition of the asset. Conversion occurs when the portion of the gain which reflects the accelerated deductions taken against ordinary income is taxed as capital gains. (Also, if the taxpayer is in a lower income tax bracket in the later years, he effectively "converts" the tax rate, too.)

The following discussion deals generally with tax shelter investments as an overview to the whole area. The analysis of each activity (such as, real estate, farming, oil and gas, equipment leasing, movies, etc.) will be dealt with more specifically in subsequent parts of this pamphlet.

Elements of a Tax Shelter Investment

Deferral

Deferral commonly arises in situations where taxpayers make investments in activities or businesses which use the cash basis method of accounting and are permitted to take certain deductions (such as cattle feed or vineyard development costs) into account for tax purposes in the first year and the other early years of the shelter investment before the investment produces any income. Deferral also occurs where taxpayers are permitted to accelerate certain deductions (such as depreciation) to the early years of an investment transaction.

The "bunching" of deductions in the first years, rather than ratably over the life of the property, is used to offset (shelter) an individual's other income. That is, excess accelerated deductions result in losses which are then used against his other investment and earned income and may significantly reduce the individual's tax liability. However, the taxes that are reduced in the earlier years may be shifted to later years when the investment begins to generate income, and many of the offsetting deductions have been used and are thus no longer available. Taxpayers in this situation have frequently found it advantageous to invest in another tax shelter to provide a "rollover" or further deferral of the taxes.

The net effect of deferral may be viewed as an interest-free loan to the taxpayer from the Federal Government during the period of the tax deferral. Over a period of years, this "loan" can be worth a substantial amount of money. For example, if a taxpayer has $100,000 of accelerated deductions and invests the tax savings in 7% tax-exempt bonds (with interest compounded annually) his money will double in less than 11 years. In other words, deferral can be worth as much as total tax forgiveness after a period of time.

In addition, in many cases, especially where leverage is used, as discussed below, a tax shelter investment also results in a taxpayer completely recovering his investment (and in some cases more) by the acceleration of the deductions. This is often the case for taxpayers in the 50-percent or higher tax brackets. Thus, not only does the Federal Government provide an interest-free loan, but in a sense the Government provides the risk capital to high bracket taxpayers to enter into these investments.

It is important to note that this deferral treatment benefits those in the higher brackets proportionately more than it benefits those in the lower brackets. For example, for each $100 deduction, a taxpayer in the 70-percent bracket will save $70 by taking that deduction against his income. On the other hand, a taxpayer in the 20-percent bracket will save only $20 when that $100 deduction is used to offset his income. This is particularly important in a tax shelter investment because of the various risks that are involved. In other words, the interest free loan for the upper income taxpayer is $70; the interest free loan for the lower bracket taxpayer is considerably less.

It should be noted that the tax benefits from deferral are greater in some tax shelters than in others simply because the deferral is for a longer period than for other investments; that is, taxes are deferred over a longer period of time. In the case of the shorter deferrals it is possible for an individual to rollover his investment; that is, to make another tax shelter investment to provide new accelerated deductions and thus defer tax liability further into the future.

Effect of progressive rate structure.—One of the risks in a tax shelter is that the investment may result in a true economic loss where the taxpayer may lose his entire investment. If this were the case (not taking into account the use of borrowed money, as discussed below), a taxpayer in the 70-percent bracket would lose only $30 of his own money; whereas, a taxpayer in the 20-percent bracket would lose $80. Therefore, the high bracket taxpayer would be willing to make riskier investments because his potential net loss (that is, the tax benefit less any economic loss) is less. In effect, the Federal Government finances more of the investments, and take more of the risks, for a high bracket taxpayer than a low brack taxpayer.

It should be noted that in the case of a taxpayer with only "earned income" subject to a maximum tax rate of 50 percent, tax shelter deductions reduce income at the 50 percent and lower rates. However, when the tax shelter investment is disposed of at other than capital gains rates, gains may be taxed as high as 70 percent, since they will be investment income and thus not eligible for the 50 percent maximum rate on earned income.

Leverage

The second element of a tax shelter investment is "leverage," which is the use of borrowed money by an individual in the investment. Generally, an individual will borrow money (or money will be borrowed on his behalf) which will equal or exceed his equity investment. There are two benefits in the use of borrowed funds, the first being an economic benefit and the second being a tax benefit. From an economic standpoint, the more that an individual can use borrowed money for an investment the more he can use his own money for other purposes (including other investments) and the more he can make on an investment which is profitable. From a tax standpoint, borrowed funds are treated in the same manner as a taxpayer's own funds that he has put up as equity in the investment. Since a taxpayer is allowed deductions not only with respect to his equity but also on the borrowed funds, he can maximize deferral by incurring deductibe expenditures which exceed his equity investment.

A simple illustration of the use of leveraging in tax shelter investments is as follows: Assume the investment requires $100,000 of capital. If an individual invests $10,000 of his own money and is able to borrow $90,000 to meet the $100,000 requirement, for tax purposes he is treated as having $100,000 in the investment. This means that if there are accelerated deductions of $20,000 in the first year, the individual, if he is in the 70-percent bracket, would be reducing his tax liability by $14,000. In this case, the tax deduction in the initial year ($20,000) would be $10,000 more than the equity capital invested and his tax savings would be $4,000 more than the amount originally invested ($10,000). This individual would be financing his investment completely with what can be referred to in effect as an interest-free loan from the Federal Government. In this example above, a taxpayer in the 50-percent bracket would recover his entire investment in the initial year; that is, if he invests $10,000 of his own money and is allowed to deduct $20,000, he receives back by way of reduction of his tax liability the $10,000 he invested. This is the reason why most tax shelter investments are advertised for taxpayers in the 50-percent bracket and above.

A taxpayer in the 20-percent bracket who invests the same $10,000, as in the above example, would only receive back $4,000 from the same $20,000 tax write-off in the first year and, therefore, he is still out of pocket $6,000 in the first year. Not only is the low bracket taxpayer less likely to have the funds to invest in these investments but the Federal Government does not provide him the same subsidy as it does for the high bracket individual.

As can be seen from this example, in the initial years, the risks to a high bracket taxpayer are rather minimal because in the normal tax shelter investment, he would recover the entire amount of his own investment in the year it is made through tax deductions. It should be noted, however, that even if the investment fails, there is usually some recovery (and sometimes substantial recovery) of previous writeoffs where the investor would be liable for tax on the constructive income he is required to recognize when the shelter terminates. This is often referred to as the "phantom gain"; where there is gain for tax purposes, even though the investment does not generate economic income or positive cash flow. In other words, the taxpayer is required to repay his interest free loan from the Government, at least to the extent of any nonrecourse borrowings which he was previously able to deduct. (Sometimes this repayment must be made in full, and sometimes only in part, if there is a "conversion" feature to the shelter, as discussed below.)

The use of leverage has increased significance when an investor is not even liable on the borrowed money, which is often the case in tax shelter investments. This is what is referred to as "nonrecourse financing." Where a partnership (usually a limited partnership) is being used as the investment vehicle, a loan may be made to the partnership so the partnership assets are subject to liability but the investors are not personally liable for the loan. However, under partnership tax regulations, the limited partner investor is entitled to increase his basis in his investment by the amount which is treated as his proportionate share of the liability (even though in fact he has no such liability). (A partner may deduct partnership losses to the extent of his basis.) Thus, the investor is able to take tax write-offs on account of the accelerated deductions not only for the money he invested (on which he is at risk) but, more significantly, also on his share of the nonrecourse aspects of tax shelter investments. (Nonrecourse loans are discussed below in connection with limited partnerships.)

Conversion of ordinary income into capital gains

A third aspect which is present in some tax shelter investments is referred to as "conversion," which is the process of converting ordinary income deductions into capital gains.

When a taxpayer depreciates an asset, he takes a deduction against his ordinary income (and thus reduces taxable ordinary income) for depreciation. If the asset is a capital asset when it is sold and the proceeds exceed basis,[1] there is a taxable gain. However, even though the previous reduction in basis (depreciation) reduced ordinary income, this gain may be taxed as capital gain. When the gain is a capital gain, the effect of the sale is to convert ordinary income, that is the income which was reduced by the previous accelerated deductions at the marginal bracket of the taxpayer, to capital gains taxed at the preferential capital gains rates.

In several cases, Congress has dealt with this situation by requiring a portion of the gain on a sale or other disposition to be treated as ordinary income rather than capital gains, to the extent of accelerated depreciation deductions (and in the case of personal property, to the extent of all depreciation). This is what is referred to as "recapture." The taxes on the ordinary income that have been deferred through the taking of accelerated deductions in earlier years are recaptured at the time the property is disposed of. Although there are several recapture rules in present law today, the recapture rules do not apply to all tax shelter investments. (In addition, the "recapture" applies only to prevent the conversion of ordinary income to capital gains; it does not apply to the deferral factor.)

Use of Limited Partnerships

The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership, which, upon meeting certain requirements, is subject to the partnership rules of the Internal Revenue Code. In general, a partnership is not considered a separate entity for tax purposes; rather the individual partners are taxed currently on their share of the partnership gains and can deduct partnership losses to the extent of the basis of their partnership interest.

When an investor enters a partnership, his basis in the partnership generally includes the amount he invested and his share, if any, of the partnership liabilities. In this regard, the income tax regulations (Regs. § 1.752–1(e)) provide that a limited partner may include in the basis of his partnership interest his share of the nonrecourse loans to the partnership even though he is not personally liable on the debt. (Such loans usually are secured only by the partnership property.) Nonrecourse financing facilitates the use of limited partner-

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[1] The initial tax basis of property usually is its cost but this tax basis is reduced to the extent that the property is being depreciated; that is, to the extent the total capital expenditures have been amortized over the life of the property at the time of the disposition. Thus, to the extent the depreciation or other capital expenditures are accelerated, the tax basis of the property is reduced faster in the earlier years. If the property is sold, the gain may be greater because the tax basis is lower than it otherwise would be if accelerated deductions had not been taken.

ships for tax shelter investments because the investor is able to limit his liability to the amount he has actually invested but use nonrecourse loans obtained by the partnership to substantially increase his basis and thus increase his tax deductions.

More specifically, these general principles apply to limited partnerships in tax shelter investments:

1. The limited partnership is not a taxpaying entity, but instead is a tax conduit, the partners reporting their distributive shares of partnership income or loss.

2. Subject to the restriction that its purpose not be to avoid or evade tax, a limited partnership agreement may provide for the manner in which the partnership's items of income, gain, loss, deduction or credit will be allocated among the partners.

3. The amount of losses which a partner may deduct for a particular year is limited to the amount of the adjusted basis of his partnership interest as of the end of the year. At the inception of a partnership, the adjusted basis of the partner's partnership interest equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities. In the case of a limited partnership, a limited partner's share of the partnership liabilities is his pro rata share (the same proportion in which he shares profits) of all liabilities with respect to which there is no personal liability ("nonrecourse liability"). This rule, where a limited partner's adjusted basis in his partnership interest is increased by a pro rata amount of nonrecourse liability, is one of the cornerstones of tax shelter investments, allowing the investor, in many cases, to currently deduct amounts in excess of his actual investment.

The limited partnership is generally preferred over the general partnership because the limited partners, who are passive investors in most cases, have limited liability for the debts of or claims against the partnership.

Corporations

The corporate form of doing business generally does not lend itself to tax shelter investments by individuals since the corporation is the taxpaying entity and, therefore, the tax incidents of its operation remain at the corporate level and do not pass through to its shareholders. The one exception to this treatment is for Subchapter S corporations. To a great extent, the tax incidents of a Subchapter S corporation's operations pass through to its shareholders. However, there are certain tax limitations applicable to the Subchapter S corporation (and to its shareholders) which are not imposed upon a limited partnership under the partnership provisions. These limitations generally make Subchapter S corporations less attractive as a vehicle for tax shelter investments.

As previously noted, one of the principal tax shelter benefits obtained under the partnership tax provisions is that the adjusted basis of an individual partner in his partnership interest not only includes his cash investment but also a pro rata share of any nonrecourse liability of the partnership. By contrast, the adjusted basis of the shareholders of a Subchapter S corporation in their stock includes their investment in the stock and any loans they may have made to the corporation, but, most signficantly, does not include any portion of the corporation's liabilities. In both cases, that of the Subchapter S corporation shareholder and the limited partner, it is the adjusted basis in partnership interest or stock, as the case may be, which serves as the upper limit on the amount of loss that may be deducted by the shareholder (partner) in a given year. Thus, in comparison to the limited partner, the Subchapter S corporation shareholder is severely limited in terms of the amount of losses, and therefore tax shelter, available.

Other limitations which apply only to Subchapter S corporations are: (1) A Subchapter S corporation may not have more than ten shareholders; (2) Trusts may not be shareholders of a Subchapter S corporation; (3) A Subchapter S corporation may not have two or more classes of stock; (4) No more than 20 percent of a Subchapter S corporation's gross receipts may be derived from passive investment income, which includes, among other things, certain types of rental income; (5) No provision may be made for special allocation of losses and other items to the shareholders, these items being allocated strictly in proportion to stock ownership.

Summary of Major Tax Shelter Investments and Their Related Tax Deductions

This part of the overview discussion presents a list of the business activities which investors often enter chiefly for tax benefits from special kinds of deductions. This part also sets forth the principal deductions which are relied on for "tax shelter" in each industry. The main characteristics of these deductions is that they are all accelerated in some manner, providing for the deferral of taxes.[1] In each of these shelters leverage can be an important factor which can magnify the deductions which are indicated.

Specialized investment area	Key shelter-producing deductions or other benefit
A. Real estate	
1. Residential rental apartments, FHA-subsidized housing, office buildings, shopping centers.	a. Interest on construction period financing. b. Construction period taxes. c. Accelerated depreciations. d. Capital gain on sale.
2. Land.	a. Current expensing of taxes, interest and certain other land development costs. b. Capital gain on sale.

[1] Many of the deductions listed are available only to taxpayers who report on the cash method of accounting, and thus can deduct expenses when and as they pay them and are not required to use inventories in their business operations.

Specialized investment area	Key shelter-producing deductions or other benefit
3. Rehabilitation of low-income rental housing.	a. 60-month depreciation. b. Capital gain on sale.

B. Farming

Specialized investment area	Key shelter-producing deductions or other benefit
1. Cattle feeding.	a. Feed costs (including prepaid feed costs). b. Other direct costs of fattening the animals.
2. Cattle breeding (also breeding other kinds of livestock such as horses, mink, hogs, etc.)	a. Feed and other raising expenses (including breeding fees). b. Accelerated depreciation of purchased animals. c. Additional first year depreciation. d. Investment credit (except on horses.) e. Capital gain on sale.
3. Raising certain vegetables or plants.	Expensing of growing costs.
4. Shell eggs.	a. Costs of laying hens. b. Raising costs (including feed).
5. Agricultural crops, vineyards, fruit orchards, Christmas trees.[1]	a. Development and raising costs. b. Accelerated depreciation on underlying grove (after crop matures. c. Investment credit. d. Capital gains on sale.
6. Thoroughbred horse racing.	a. Maintenance costs. b. Stud fees. c. Capital gain on sale.

[1] Citrus and almond grove costs must be capitalized (sec. 278).

Specialized investment area	Key shelter-producing deductions or other benefit
C. Oil and gas drilling	a. Intangible drilling costs. b. Capital gain on sale.
D. Equipment leases (e.g., computers, airplanes, ocean-going vessels, railroad cars, CATV systems, etc.)	a. Accelerated depreciation or 5-year amortization. b. First-year "bonus" depreciation. c. Investment credit (corporate lessors only).
E. Motion pictures	
1. Purchase of completed picture.	a. Accelerated depreciation. b. Investment credit.
2. Production of a picture.	Expensing of production costs.
F. Professional sports franchises	a. Rapid depreciation of player contracts. b. Payroll and other operating costs. c. Capital gains.
G. Deductions available generally	a. Interest on borrowed funds used to finance costs of acquiring the investment and to pay some of the deductible expenses. b. Real estate, sales and use taxes. c. Various prepaid expense items. d. Miscellaneous commissions, fees for professional services, etc.

Summary of Provisions in Tax Reform Act of 1969 Affecting Tax Shelters

The Tax Reform Act of 1969 was a substantive and comprehensive reform of the income tax laws generally and dealt either directly or indirectly with a number of the provisions involving tax shelter investments. Although many tax preferences were dealt with directly by the 1969 Act, in most cases these were not eliminated but only reduced in certain respects. Certain tax preference provisions were not affected at all by the 1969 Act because it was believed inappropriate to make any change in those areas at that time. However, since 1969 (and especially in the early 1970's), tax preferences have been packaged and promoted in tax shelter investments to an increasingly significant extent.

A brief summary of the 1969 revisions and reforms relating to tax shelter investments follows:

Real estate

In the case of real estate, the 1969 Act substantially limited real estate depreciation allowances. The 200-percent declining balance method and other accelerated forms of depreciation were restritced to new residential housing. Depreciation with respect to other new real estate was restricted to the 150-percent declining balance method. Used properties acquired in the future were limited to straight line depreciation, except for used residential housing which was made eligible for allowances at 125 percent of the straight line method where the property still has a useful life of more than 20 years. In addition, stricter recapture rules were imposed, particularly for nonresidential property, so that a larger proportion of gain on the sale of property (which resulted from accelerated depreciation allowances taken previously) is taxed as ordinary income.

Farm operations

In the case of farm operations, the 1969 Act made a series of changes. Taxpayers deducting farm losses against their non-farm income generally must treat capital gains arising on the subsequent sale of farm assets as ordinary income. For individuals, this recapture rule applies only to losses over $25,000 and only if nonfarm income is over $50,000. The Act also provided for the recapture of depreciation on the sale of livestock and a more effective treatment of hobby losses. The holding period for capital gain treatment with respect to cattle and horses was extended, provision was made for the recapture of soil and water conservation or land-clearing expenditures on the sale of farm land held less than 10 years, and the costs of developing citrus groves were required to be capitalized.

Natural resources

In the case of natural resources, the Act made several significant revisions, the main one being the reduction of the percentage depletion allowances. The percentage depletion rate for oil and gas wells was reduced from 27½ percent of gross income to 22 percent. (The

Tax Reduction Act of 1975 eliminated percentage depletion for the so-called "majors" and provided for a reduced allowance for so-called "independents.") In the 1969 Act, the depletion rate was also cut to 22 percent for minerals eligible for a 23 percent rate under prior law and to 14 percent for most minerals eligible for a 15 percent rate under prior law.

Carved-out and other production payments (including ABC transactions) were treated as if the payments were loans by the owner of the payment to the owner of the mineral property. This prevented the use of carve-outs to increase percentage depletion payments and foreign tax credits. It also eliminated the possibility of purchasing mineral property with money which was not treated as taxable income to the buyer. Finally, recapture rules were applied to mining exploration expenditures not subject to recapture under prior law and the foreign tax credit was disallowed to the extent foreign taxes were attributable to the deduction allowed against U.S. tax for percentage depletion.

Capital gains and losses

The 1969 Act eliminated the alternative tax on long-term capital gains for individual taxpayers to the extent they have capital gains of more than $50,000. Long-term capital gains up to the first $50,000 received by individuals continues to qualify for the 25-percent alternative capital gains tax rate. The maximum tax rate on that part of long-term capital gains above $50,000 was increased (over a 3-year period) to 35 percent (one-half of the 70-percent top tax rate applicable to ordinary income). The alternative tax rate on corporate long-term capital gains income was increased (over a 2-year period) from 25 percent to 30 percent.[1]

Interest deduction

The 1969 Act limited the deduction for interest paid or incurred by a taxpayer (other than a corporation) on funds borrowed for investment purposes to 50 percent of the interest in excess of the taxpayer's net investment income, his long-term capital gains and $25,000. The disallowed interest, however, may be carried over to subsequent years. (This provision had a 2-year delay in effective date.)

[1] In addition, the Act required net long-term capital losses (in excess of net short-term capital gains) of individuals to be reduced by 50 percent before they offset ordinary income. (The limitation on the deduction of these losses against ordinary income was retained at $1,000. Where separate returns were filed, the deduction of capital losses against ordinary income was limited to $500 for each spouse.) Ordinary income tax treatment instead of capital gains treatment was provided for (1) gains from the sale of memorandums and letters by a person whose efforts created them (or for whom they were produced), (2) transfers of franchises, trademarks, and trade names where the transferor retains significant rights, powers, or continuing interests, and (3) contingent payments received under franchises, trademark, or tradename transfer agreements. (In addition, corporations were allowed a three-year loss carryback for net capital losses.)

Minimum tax

To supplement the specific remedial provisions of the Act in curtailing tax preferences, a minimum tax was enacted which applies to both individuals and corporations. It is computed by (1) totaling the amount of tax preferences received by the taxpayer (from the categories of tax preferences specified in the Act), (2) subtracting from this total a $30,000 exemption and the amount of the taxpayer's regular Federal income tax for the year (plus any carryovers from prior years), and (3) applying a 10-percent tax rate to the remainder. The maximum tax is payable in addition to any regular income taxes to which the taxpayer is subject.

Maximum tax on earned income

The 1969 Act provided that the maximum marginal tax rate applicable to an individual's earned income is to be 50 percent. It was concluded that the higher rates of tax (that is, the top marginal rate of 70 percent), were inappropriate in the case of earned income.

In addition, the 50-percent limit on the tax rate applicable to earned income was adopted as a means of reducing the pressures for the use of tax avoidance devices. As a result, for purposes of the maximum tax provision, earned income eligible for the 50-percent top rate is reduced by tax preferences in excess of $30,000.

Public Syndication of Tax Shelter Investments

Tax shelters are not a new form of investment, nor were they created by the public syndicators of interests in real estate and other limited partnerships. The advantage of owning an apartment building, for example, both for current income and for accelerated depreciation, has long been familiar to doctors, lawyers, and other high-income professionals and businessmen. Real estate syndicates of individuals have been formed for many years, usually involving a builder and a small group of individuals who personally know each other. However, the widespread public sales of shares in investments in real estate, farming, oil drilling, motion pictures and the like (many of which involve registering the offering with the Securities and Exchange Commission and selling it like a stock interest) has been a phenomenon of recent years, reflecting efforts by promoters to pass through tax shelter benefits to passive outside investors.

This form of mass merchandising, which has received much publicity in recent years, is basically a reflection rather than a cause of tax shelter benefits in present law. Some critics of tax shelters believe, however, that the public syndication of specialized investments to absentee owners has created a preoccupation with tax benefits (rather than with the economic merits and risks of the project) to the neglect of future tax liabilities.

Some of those who share this view argue that the tax provisions which Congress intended as incentives work well so long as they are not carried to extremes, but when an investment is made chiefly to intensify "tax writeoffs," the tax rules become distorted and cease to work as they were intended.

Table 1 shows the trend since the Tax Reform Act of 1969 in the number and volume of publicly syndicated tax shelter offering registered with the National Association of Securities Dealers.

The trend indicates that publicly syndicated tax sheltering offerings since the 1969 Act increased from 1970 through 1972 but began to decrease in 1973 and then started to drop off sharply in 1974 and 1975. It should also be noted, however, that public syndications registered with the National Association of Securities Dealers make up only a very small number of the actual tax shelter investments. There are many more private syndications (or public syndications) which are not required to be registered. Moreover, this decline may be explained in part by the general economic downturn that existed in 1974 and most of 1975.

TABLE 1.—TREND IN PUBLICLY SYNDICATED TAX SHELTER OFFERINGS SINCE THE TAX REFORM ACT OF 1969

The following data shows partnership offerings registered with the National Association of Securities Dealers. The figures include offerings made in interstate and intrastate transactions, but only those made through securities dealers who are members of NASD. The figures do include some private placements but not offerings made through securities dealers who are not members of NASD. The figures show the total dollar amount offered to the public but not the amount actually sold.

Offering	1970 Number	1970 Dollars registered	1971 Number	1971 Dollars registered	1972 Number	1972 Dollars registered
Oil and gas	62	$664, 337, 000	155	$740, 093, 579	230	$1, 110, 607, 895
Real estate	54	256, 485, 390	139	523, 534, 085	207	787, 735, 062
Vintage and farming	3	10, 742, 000	7	30, 226, 611	20	34, 568, 034
Cattle feeding and breeding	13	26, 764, 000	22	244, 636, 000	31	193, 512, 000
Miscellaneous [1]	13	26, 336, 260	11	29, 915, 620	19	55, 256, 800
Total	145	984, 664, 650	334	1, 568, 405, 895	507	2, 181, 679, 791

Offering	1973		1974		1975	
	Number	Dollars registered	Number	Dollars registered	Number	Dollars registered
Oil and gas	228	$908, 615, 170	158	$836, 006, 102	121	$575, 994, 990
Real estate	172	849, 436, 164	94	521, 457, 932	76	341, 425, 001
Vintage and farming	29	59, 894, 880	17	29, 666, 600	4	2, 465, 150
Cattle feeding and breeding	47	329, 111, 000	18	142, 561, 010	8	27, 845, 000
Miscellaneous [1]	28	205, 712, 000	19	98, 446, 190	33	57, 457, 300
Total	504	2, 352, 769, 214	306	1, 628, 137, 834	242	1, 005, 187, 441

[1] Includes equipment leasing (computers, tank cars, aircraft, cable TV, etc.), mining, theatrical and motion picture productions, commodity funds, race tracks, auto racing and restaurant investments. Does not include equipment leasing by banks.

Source: National Association of Securities Dealers, Inc.

Current Positions of the Internal Revenue Service With Regard to Tax Shelter Investments

Over the last several years, the Internal Revenue Service has taken an active role in reviewing various aspects of tax shelter investments. This involves a review of past, as well as present, positions with respect to arrangements which are packaged in the form of tax shelter investments to determine whether they meet the requirements to allow the special tax benefits.

A summary of the various rulings published by the IRS in the general area of tax shelter investments appears below.

Advance Rulings for Partnership Tax Treatment

Under present law, if the purpose of a transaction is tax avoidance, the transaction may be set aside for Federal tax purposes, with the result that the taxpayer will not receive the deductions resulting from the transaction to which he would otherwise be entitled. See *Court Holding Co.* v. *Commissioner*, 324 U.S. 331 (1945). As a result, the Service generally will not issue a ruling letter with respect to any transaction where there is a serious question as to whether or not the principal purpose of the transaction is tax avoidance.

In recent years the Service has issued Revenue Procedures setting forth certain conditions that must be met before the Service will issue a favorable ruling that a limited partnership will be treated as a partnership for Federal tax purposes.

In Rev. Proc. 74–17, 1974–1 C.B. 438 (TIR–1290, issued May 3, 1974), the IRS set forth certain guidelines which it will apply in determining whether the formation of a limited partnership is for the principal purpose of reducing Federal taxes. If the requirements of Rev. Proc. 74–17 are not satisfied, no ruling letter will be issued. However, the taxpayer is still free to argue (with an Internal Revenue agent, or before a court) that he is entitled to the deductions claimed in connection with the partnership.

The IRS guidelines contained in Rev. Proc. 74–17 are as follows:

(1) All of the general partners, in the aggregate, must have at least a one percent interest in each material item of partnership income, gain, loss, deduction or credit.

(2) The aggregate deduction of the limited partners during the first two years of the partnership's operations cannot exceed the amount of the equity investment in the partnership.

(3) No creditor who makes a nonrecourse loan to the partnership may acquire, as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership, other than as a secured creditor.

Nonrecourse Loans

In many situations, so-called "nonrecourse loans" bear a striking resemblance to, and in substance are, equity contributions to the limited partnership. In 1972, the Service issued two Revenue Rulings pertaining to certain alleged to be nonrecourse loans. While both rulings dealt with and had particular application to limited partnerships engaged in gas and oil exploration, they are susceptible to a much broader application.

In Rev. Rul. 72–135, 1972–1 C.B. 200, the Service ruled that an alleged nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would be treated as a contribution to the capital of the partnership by the general partner, and not as a loan, thereby precluding an increase in the bases of the limited partners' partnership interests with respect to any portion of such loans. In Rev. Rul. 72–350, 1972–2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by a highly speculative and relatively low value property of the partnership, and which was convertible into an equity interest in the partnership's profits, did not constitute a bona fide loan, but was, in reality, an equity contribution to the partnership.

In recently issued Rev. Proc. 74–17, the Service stated that it would not issue an advance ruling granting partnership status to a limited partnership where a creditor had made a nonrecourse loan to the partnership and could acquire at any time, as a result of such loan, a direct or indirect interest, other than as a secured creditor, in any profits, capital or property of the partnership.

Prepaid Interest

Prepaid interest deductions are frequently claimed in tax shelter ventures. In 1968, the IRS issued Rev. Rul. 69–643, 1968–2 C.B. 76, which, using distortion of income as its main criterion, in effect, restricted prepayment of interest to the taxable year succeeding the year of prepayment. Moreover, the IRS cautioned that even with respect to those prepayments for the year succeeding the year of prepayment (i.e., for a period not more than 12 months beyond payment), material distortions of income could result in a disallowance of all or part of such prepayment. Recently, the position taken by the Service has been sustained, for the most part, in two cases, *Sandor*, 62 T.C. 469 (1974), (prepayment of five years' interest), and *Burck*, 63 T.C. 556, (1975), (prepayment of one year's interest).

Prepaid Feed Deduction

One of the major tax shelter deductions in the farming area has derived from prepayments at the end of the year for livestock feed to be consumed in a following taxable year. Concerned with the possible resulting distortion of income and whether such prepayments have a bona fide business purpose, the Service issued Rev. Rul. 75–152, 1975–17 I.R.B. 15. This ruling requires that (for a current year's deduction to be available) the prepayment be for the purchase of feed, rather than a mere deposit; that it be for a business purpose and not merely for tax avoidance; and that the deduction in the year of prepayment not result in a material distortion of income. (It should be noted that those actively engaged in farming as their principal occupation frequently claim deductions for prepaid feed expenses.)

Syndication and Organization Fees

Until recently, it had been common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. However, in Rev. Rul. 75–214 (1975–23 I.R.B. 9), the Service ruled that such payments to general partners for services rendered in organizing and syndicating a partnership constituted capital expenditures which were not currently deductible.

Equipment Leasing

The tax shelter expectations of the parties to a lease of personal property which, in most cases, is leveraged [1] are dependent upon the transaction being treated as a lease and not as some form of sale of the property involved. In the mid-1950's, the Service issued a number of rulings, and recently issued Revenue Procedure 75–21 (I.R.B. 1975–18, 15) setting forth the criteria to distinguish between what is a bona fide lease and a sale of property. Under these Rulings and Revenue
The tax shelter expectations of the parties to a lease of personal
Procedure, the terms of the lease agreement in question will be closely scrutinized and, if the economic substance is such that it more closely resembles a sale of property, as opposed to a lease, lease treatment, and the resulting tax advantages flowing therefrom, will not be accorded the parties to transaction. One of the main requirements to be met for the lessor to be treated as such, is that he must maintain a minimal and unconditional investment in the property in question.

Intangible drilling and development costs

One of the basic tax deductions commonly used in oil and gas tax shelters is that for intangible drilling costs which, essentially, consists of amounts paid for labor, fuel, repairs, hauling, and supplies, etc. which occur in connection with the drilling of wells for the production of oil or gas. To the extent an item (e.g., pipe) has a salvage value, it does not qualify as an intangible drilling cost. The deduction of intangible drilling costs is elective with the taxpayer.

In Rev. Rul. 68–139, 1968–1 C.B. 311, the IRS ruled that a limited partnership may earmark a limited partner's contribution to expenditures for intangible drilling costs, thereby allowing the allocation of the entire deduction to the limited partners (if the principal purpose of such allocation is not the avoidance of Federal taxes).

In another ruling in this area, Rev. Rul. 71–252, 1971–1 C.B. 146, the Service has ruled that a deduction may be claimed for intangible drilling costs in the year paid, even though the drilling was performed during the following year, so long as such payments are required to be made under the drilling contract in question.[2]

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[1] A "leveraged lease", recently having become a very popular financing and tax shelter device, typically involves three parties—the lessor, the lessee and the lender. It may be defined as a net lease of property for a substantial part of the useful life of such property, where a substantial part of the purchase price of such property is obtained through borrowing by the lessor, and where the rents paid by the lessee are at least sufficient to amortize the lessor's borrowings. It is the substantial borrowing of the lessor, which usually is on a nonrecourse basis, which adds the "leverage" aspect to what otherwise might be described as a "straight lease" transaction. The lender does take a security interest in the leased property and, as a matter of practice, looks to the credit worthiness of the lessee before making the loan.

[2] See also Rev. Rul. 71–579, 1971–2 C.B. 225.

Current Positions of the Securities and Exchange Commission With Regard to Tax Shelter Investments

The Securities and Exchange Commission ("SEC") has also taken an active role over the last several years in reviewing various aspects of tax shelter investments. Under the full disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, any material risks of adverse tax consequences must be fairly disclosed to prospective investors. Mindful that certain tax shelter benefits sometimes constitute a substantial investment inducement and that certain issues of Federal tax law relating to tax shelters are as yet unsettled, the SEC requires certain disclosures regarding various aspects of tax shelters which may involve material risks of adverse tax consequences. Although only public offerings of securities must be registered with the SEC, the anti-fraud provisions of Federal securities laws apply to private and intrastate as well as public offerings. Consequently, while SEC disclosure requirements and policies have direct application only to public offerings, they also have indirect application to intrastate and private offerings.

Qualification for partnership tax treatment

In tax shelters, it is of critical importance that a limited partnership be treated as a partnership for tax purposes in order that the tax benefits generated by the partnership pass through to, and may be used by, the limited partners. In many instances, a limited partnership will not apply for an advance ruling that it has partnership tax status, but, instead, obtains an opinion of counsel to this effect. In these cases, the SEC requires a disclosure that no advance ruling was obtained, that the opinion of counsel is not binding on the IRS, and that, in the event of the reclassification of the limited partnership as an association taxable as a corporation, investors would lose the pass-through of tax benefits.

Nonrecourse loans

Generally, the SEC suggests appropriate risk disclosures as to the possible applicability of Rev. Ruls. 72–135 1972–1 C.B. 200 and 72–350 1972–2 C.B. 394 in which the Service held that certain "nonrecourse loans" were, in substance, equity contributions to the oil and gas exploration limited partnership involved. (See Internal Revenue Service—Nonrecourse Loans, above). Less emphasis is placed on such disclosures in real estate partnerships than in exploratory oil and gas drilling partnerships.

Prepaid interest

With respect to a real estate limited partnership which deducts a large interest prepayment in its first year of operation and which has little or no income in such year, the SEC suggests a disclosure to the effect that the IRS may disallow the prepayment on the ground that it constitutes a distortion of the partnership's income and that the IRS would allocate the deduction for such prepayment ratably over the term of the loan.

Prepaid feed deduction

In cattle-feeding partnership registration statements, the SEC requires a cover-page disclosure to the effect that there is a substantial risk that the IRS will disallow a deduction, and thus reduce or eliminate contemplated tax benefits, for payments for cattle feed which will be consumed in a taxable year following that of payment.

Intangible drilling and development costs

Currently, the SEC does not require extensive risk disclosures with respect to prepayments of intangible drilling costs.

Management fees

Many limited partnerships make rather sizeable payments of what is referred to as "management fees" to general partners of the partnership. These fees, which often are deducted in the year of payment by the partnership, many times relate to services in organizing the partnership and services that will be rendered in taxable years following the year of payment. As to the deductibilty of these fees, the SEC suggests risk disclosures to the effect that they will not be deductible if they constitute a capital expenditure or if they represent unreasonable compensation.

Partnership allocations

While section 704 of the Internal Revenue Code provides the flexibility for allocating among partners various partnership items of income, deductions and credits, these allocations may be disregarded under existing law if their principal purpose is the avoidance or evasion of income taxes. With respect to these special allocations, including retroactive allocations to new partners, the SEC requires an opinion of counsel that they do not have tax avoidance as their principal purpose and/or a disclosure to the effect that the special allocation may be disregarded upon an IRS audit of the partnership's returns.

2. GENERAL APPROACHES TO REVISION

Should the committee decide to deal directly or indirectly with tax shelter investments there are a number of possible alternative approaches that might be utilized. If it is determined that certain incentives are no longer desirable or that the tax benefits from the preferences are greater than they need be, those provisions could be revised directly; that is, the particular provisions could be eliminated or cut back to some extent.

If it is determined that certain incentives should be continued but that the tax benefits involved should not be available to be used to offset income unrelated to that particular activity, the tax benefits could be limited to the income from that particular activity, thus, not allowing excess deductions to be used to shelter other income. This is basically the LAL approach (limitation on artificial accounting losses) which was proposed by the Administration and essentially adopted in the House bill reflects this approach.

A third approach is to deal with tax shelter investments through the minimum tax. This is the approach that the Congress took in 1969 when it enacted a minimum tax to make sure that taxpayers paid at least some tax on those specified tax preferences that were determined appropriate to continue for the desired economic or social purpose.

As indicated above, the House dealt with tax shelters essentially in the LAL provisions. However, the House bill also includes a number of other provisions dealing with related aspects of tax shelters, such as the use of nonrecourse loans and the conversion of ordinary income into capital gains. These provisions of the House bill are briefly described at the end of this pamphlet. (The House bill also modified and expanded the application of the existing minimum tax. This topic will be discussed in a subsequent pamphlet.) A subsequent tax shelter options pamphlet will focus in a more comprehensive fashion on the various methods by which the committee might deal with the question of tax shelters.

3. REAL ESTATE

General

The real estate industry is a capital intensive industry. The acquisition or construction of apartment buildings, shopping centers, commercial office buildings, hotels and motels, etc., generally requires the commitment of large amounts of capital over a relatively long period of time. To provide this capital, a number of investment vehicles have been utilized which allow investors to pool their financial resources. This pooling of investment is commonly referred to as "real estate syndication" and may be set up in any one of a number of legal forms, such as a joint venture, a partnership, a real estate investment trust, or a corporation. These various legal forms differ with respect to the investor's right of control and participation in management, rights of survivorship, personal liability, tax treatment, etc. This section of the pamphlet describes those forms of real estate investment which tend to be used most frequently to produce a "tax shelter" and analyzes the various elements which, taken together, made up a real estate tax shelter.

A real estate investment decision generally involves an evaluation of the potential risks and a comparison of those risks with the overall rate of return, including the potential cash flow, the potential for appreciation, and the potential tax benefits. The various provisions that provide tax benefits for real estate include the deduction for accelerated depreciation, the deduction for interest and taxes during the construction period, the deduction for prepaid interest, the rules of partnership taxation (including the determination of a partner's basis, especially the treatment of nonrecourse loans, and the allocation of income and losses among the partners), and capital gain treatment upon the sale of the property.

In general, a real estate tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings on other income as well as the receipt of tax-free cash flow from the investment itself. The tax savings are principally achieved by allowing current deductions, for costs, which, in the opinion of some, are properly attributable to later years. For example, during the construction period the interest paid on the construction loan and the real estate taxes are immediately deducted even though there is no income from the property. Later, after the building is completed, deductions for accelerated depreciation are permitted which, for a period of years, are generally greater than the net rental income before depreciation. These deductions (construction period costs and accelerated depreciation) combine to generate losses which can be used to offset income from other sources, such as salary and dividends. In effect, taxpayer is allowed to defer or postpone the payment of tax on current income, either by offsetting current income with loss deductions attributable to real estate or by receiving a tax-free cash flow from the real estate project, or both.

The entity most commonly used to create real estate tax shelters and produce the maximum tax benefits for an individual investor is the limited partnership. Typically, a real estate venture is syndicated as a limited partnership with the builder-entreprenuer as the general partner and the investors as limited partners. Unlike a corporation, the partnership itself is not subject to tax, but serves as a conduit through which the tax consequences of a particular project are passed to the individual partners. Thus, to the extent that the partnership incurs losses during a particular taxable year, these losses are allocated to and become the individual losses of the various partners.

A partner, including a limited partner, can deduct these losses only to the extent of the basis in his partnership interest. However, a limited partner's basis includes his share of those libalities of the partnership for which no partner is personally liable ("nonrecourse liability"). This rule relating to nonrecourse debt is extremely important in real estate since such debt financing (leverage) increases the tax benefits to the limited partners and permits them to deduct losses which exceed the amount they have at risk.

In addition, this form of business ownership has several other advantages. For example, one of the important characteristics of real estate syndication is the extent to which mortgage financing can be obtained to acquire property. It is often possible for a syndication to arrange financing for as much as 90 percent of the purchase price. The remaining 10 percent (or equity) of the purchase price can be raised by selling small shares or units in a partnership to numerous investors who become limited partners. Through the use of borrowing by the partnership, the risk of loss to the individual limited partners is minimized, since the limited partners are passive investors and their liability for the debts or claims against the partnership is limited to their investments in the partnership.

Types of Shelter Deductions

In the case of a real estate tax shelter, two types of accelerated deductions are principally utilized to generate losses: the deduction for accelerated depreciation and the deduction for construction period interest and taxes. In certain cases, prepaid interest may also be utilized, but the availability of a deduction for prepaid interest is not peculiar to the real estate tax shelter. Accelerated depreciation is generally treated as an item of tax preference under the minimum tax, but construction period costs and prepaid interest deductions are not so treated.

In addition to generating tax losses, these deductions may not subsequently be subject to recapture, thus resulting in the conversion of ordinary income into capital gain.[1]

Depreciation

Before 1946 depreciable real estate buildings generally were depreciated under the straight line method for income tax purposes (that is, a depreciation deduction of an equal pro rata amount over the useful life of the property). In 1946 administrative practices began to permit the depreciation of real estate on the 150 percent declining balance method, which had previously been available only for tangible personal property, such as machinery or equipment. Under the 1954 code, both new real property and new tangible personal property could be depreciated under either the double declining balance method or the sum of the years-digits method of depreciation by the first owner.[2] A later owner was permitted to use the 150 percent declining balance method.[3]

The Tax Reform Act of 1969 limited the extent to which accelerated depreciation would be allowed with respect to real property. Under this Act, the use of accelerated methods of depreciation depends upon the class of property involved. A description of these classes of property and the methods available for each class is provided below following a brief analysis of the depreciation methods generally.

It is important to note that depreciation is allowable with respect to the entire cost basis in the depreciable portion of the property and not merely with respect to the taxpayer's equity. Thus, if an apartment building is purchased at a cost of $120,000 ($20,000 for the land and $100,000 for the building) depreciation may be taken on the entire $100,000 cost of the apartment building even if the entire property is purchased for $20,000 cash and a $100,000 mortgage. The total depreciation taken within the first 4 or 5 years is likely to exceed the owner's entire net equity. (See table below.)

The following summarizes the first year, first 5-year, and first 10-year depreciation deduction as a percentage of a building's cost with 25- and 40-year lives under the four major alternative depreciation formulas:

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[1] Although the depreciation recapture rules are designed to prevent conversion by taxing certain gain from sales as ordinary income rather than capital gain, they do not fully recapture accelerated depreciation in all cases.

[2] The code also permits the use by the first owner of "any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the [double declining balance] methods * * *."

[3] The second owner may be able to approximate, at 1½ times declining balance, the depreciation deductions available to the first owner, since the second owner often can depreciate over a shorter useful life than the first owner. The other benefits described below (depreciation calculated upon total basis, little recapture, and generally capital gains at disposition) are available to second and subsequent owners as well as to the first owner.

[In percent]

	Straight line [4]		200-percent declining balance [5]		Sum-of-the-years digits [6]		150-percent declining balance [7]	
	25-yr life	40-yr life	25-yr life	40-yr life	25-yr life	40-yr life	25-yr life	40-yr life
Year 1	4	2.5	8.0	5.0	7.7	4.9	6.0	3.75
1st 5-year total	20	12.5	34.1	22.6	35.4	23.2	26.6	17.40
1st 10-year total	40	25.0	56.6	40.1	63.1	43.3	46.1	31.80

The use of these different methods depends, as a result of the Tax Reform Act of 1969, upon whether the property is residential rental property, non-residential property, or low income residential property. In addition, in the case of residential and non-residential property, the allowable method also depends upon whether the property is new or used.

In general, residential rental property includes single and multiple family housing, apartments, and similar structures which are used to provide living accommodations on a rental basis. A building or other structure will qualify as residential rental property if 80 percent or more of the gross rental income from the building or structure is rental income from dwelling units. Hotels, motels, inns, or other similar establishments are not treated as dwelling units if more than one-half of the units are used on a transient basis.

With respect to *new* residential property (the original use of which commences with the taxpayer), both the 200 percent declining balance method and the sum of the years digits method are allowed. (The sum of the years digits method is not allowed for any other class of real property.) Residential property which is *used* property can be depreciated at a 125 percent declining balance rate if it has a remaining

[4] The straight-line method of depreciation results in an equal annual expense charge for depreciation over an asset's useful life. For purposes of computation, the straight-line rate is determined by a fraction, the numerator of which is one and the denominator of which is the estimated useful life of the asset.

[5] The 200-percent declining balance method of depreciation, more commonly referred to as double-declining balance, allows a rate equal to twice the straight-line rate. In either case, the declining balance rate is applied to the unrecovered cost, i.e., cost less accumulated depreciation for prior taxable years. Since the depreciation base is reduced to reflect prior depreciation, the amount claimed as depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

[6] The sum of the years' digits method of depreciation is computed using a fraction the numerator of which is the years' digits in inverse order and the denominator of which is the sum of the number of years. For example, if an asset has an estimated useful life of 10 years, the denominator is the sum of one plus 2 plus 3, etc., plus 10, or 55. The numerator would be 10 in the first year, 9 in the second year, etc. Thus, in the first year, the fraction would be 10/55, in the second year 9/55, etc. As in the case of the declining balance method, the annual depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

[7] The 150-percent declining balance method of depreciation allows a rate equal to 1.5 times the straight-line rate.

life of 20 years when acquired. If *used* residential property has a remaining life of less than 20 years, only straight line depreciation is permitted.[8]

The second class of property is non-residential rental property which includes buildings or other structures that are not used to provide living accommodations, such as commercial office buildings, industrial buildings, shopping centers, etc.

In the case of new non-residential property, depreciation under the declining balance method is limited to a rate which does not exceed 150 percent of the rate determined under the straight-line method.[9]

In addition to the rules relating to the two classes of property mentioned above, special amortization rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the code). Low income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. An individual or family is considered to be of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of HUD for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.[10]

Under the special amortization rules for this low or moderate income property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under the straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Only the aggregate rehabilitation expenditures as to any housing which do not exceed $15,000 per dwelling unit qualify for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Interest and taxes during construction period

Under present law, amounts paid for interest and taxes during the construction of real property are allowable as current deductions except to the extent the taxpayer elects to capitalize these items as carrying charges.[11] If an election is made to capitalize these items, the amount capitalized will be amortized over the useful life of the

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[8] Other accelerated methods may be used for residential property if the depreciation allowance under these methods during the first two-thirds of the useful life does not exceed the depreciation allowance under the applicable declining balance.

[9] Other accelerated methods may be also used for new non-residential property if the depreciation allowance under these methods during the first two-thirds of the useful life does not exceed the depreciation allowable under the applicable declining balance method. No accelerated depreciation is allowable with respect to *used* non-residential real property.

[10] The current level of eligible income for a family of four is $15,400 in Washington, D.C., $13,700 in Chicago, and $11,900 in Los Angeles. Thus, 90 percent of these limits are $13,860, $12,330, and $10,710 respectively.

[11] Interest and taxes paid or accrued during the construction period is deductible under the provisions dealing with the deductibility of interest and taxes in general (sec. 163 or 164, respectively). No deduction is currently allowable if the taxpayer elects to capitalize these expenses (sec. 166).

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building. The deduction for taxes (sec. 164) includes sales and real estate taxes paid or accrued on real or personal property during the construction period. The deduction for interest during the construction period includes amounts designated as "points" or loan processing fees so long as these fees are paid by the borrower prior to the receipt of the loan funds and are not paid for specific services.[12] (Generally, construction period interest is not presently treated as investment interest for purposes of the limitation on investment interest (sec. 163(d)) or treated as a tax preference for purposes of the minimum tax in computing the preference for excess investment interest for purposes of the minimum tax or tax preferences.

Recapture of accelerated depreciation

Under present law, net gains on the sale of real property used in a trade or business (with certain exceptions) are taxed as capital gains, and losses are generally treated as ordinary losses. However, gain on the sale of buildings is generally "recaptured" and taxed as ordinary income rather than capital gain to the extent that the gains represent accelerated depreciation taken in excess of the amount that would be allowed under the straight-line method of depreciation.

The provisions relating to depreciation recapture were first enacted in 1962 to prevent deductions for depreciation from converting ordinary income into capital gain. In general, the 1962 provision (sec. 1245 of the code) provided that gain on a sale of most tangible personal property would be taxed as ordinary income to the extent of all depreciation taken on the property after December 31, 1962. In 1964, the recapture rules were extended to real property (buildings) to provide in general that gain or a sale would be taxed as ordinary income to the extent of the depreciation (in most cases only the accelerated depreciation) taken on that property after December 31, 1963. This provision (sec. 1250 of the code), however, had a gradual phase-out of the recapture rules. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recaptured was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules were further modified as to post-1969 depreciation on real property. Under the Act, in the case of residential real property and property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, post-1969 depreciation in excess of straight-line is fully recaptured at ordinary income rates if the property has been held for more than 12 months[13] but less than 100 months (8 years and 4 months). For each month the property is held over 100 months, there is a one percent per month reduction in the amount of post-1969 depreciation that is recaptured. Thus, there will be no recapture of any

[12] See Rev. Rul. 68–643 (C.B. 1968–2, 76), Rev. Rul. 69–188 (C.B. 1969–1, 54) and Rev. Rul. 69–582 (C.B. 1969–2, 29).

[13] There was no change in the rule providing for recapture of all depreciation (including straight-line) if the property is not held for more than 12 months.

depreciation if the property is held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 221(d)(3) and the FHA 236 programs, the pre-1969 recapture rules on real property are retained.[14] However, if the property is constructed, reconstructed, or acquired after December 31, 1975, the regular post-1969 rules previously discussed above with respect to residential property will apply (i.e., a one percent reduction per month after 100 months).

Leverage

As noted previously, the amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705). Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations, where the partnership incurs a debt and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners, including limited partners, are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)).

Issues

The material below sets forth some of the principal issues with respect to the use of tax shelter ventures in real estate and the principal tax deductions commonly utilized in such ventures.

Accelerated Depreciation.—The allowance of deductions for accelerated depreciation on real property has been criticized on the ground that the economic cost attributable to the exhaustion of the depreciable portion of the property will rarely equal the amount claimed as a deduction during the earlier years of its useful life. In fact, the property may appreciate in value rather than depreciate. Moreover, it is pointed out by some that accelerated depreciation will frequently exceed the amount required to service a mortgage against the property during the early life of the property (yielding a positive cash flow from the property).

Because of the present tax situation, when an investment is solicited in a real estate venture, it is argued that it has become common practice

[14] That is, with respect to these projects, accelerated depreciation will be fully recaptured at ordinary income rates only if the property has been held for not more than 20 months. (If the property is sold within 12 months, all of the depreciation is recaptured.) For each month the property is held over 20 months, there is a 1 percent per month reduction in the amount of accelerated depreciation recaptured. Thus, there will be no recapture if the property is held for a period of 120 months (10 years).

to promise a prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources.

Construction Period Costs.—Some argue that the allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or incurred because it is necessary to produce income and is usually consumed in the process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, it is argued that under the matching concept, these expenditures should be treated as a future expense when the income "resulting" from the expenditure is received and the original investment is gradually consumed. Alternatively, it is argued that the allowance of a deduction for construction period interest should be deductible in the year paid, notwithstanding the fact that the building is in process and not yet placed in service, because the interest is a cost of financing and not a cost incurred to acquire the building; likewise, taxes paid during the construction period are period costs, not capital costs, because they do not add value to the underlying assets.

In addition, when a building is sold, any realized gain may be eligible for capital gains treatment to the extent accelerated depreciation is not recaptured as ordinary income. However, there is no recapture with respect to the construction period interest and taxes.

Many argue that the provisions of present law providing incentives are essential to attract investment in an industry already suffering from a shortage of capital. Without these incentives, they urge, the capital shortage problem will be severely aggravated.

4. FARM OPERATIONS

General

Farm operations generally involve raising animals and plants to provide food and fiber in the United States and abroad. As with other businesses, most taxpayers are engaged in farming operations principally in order to derive economic profits from them. Some taxpayers, however, acquire farms or ownership interests in farm activities because several special tax rules that apply to farm operations can be used to shelter income earned in other economic activities. The major tax advantages are a deferral of tax payments for one or more years, deferral until the taxpayer's taxable income falls to a lower marginal tax bracket, or conversion of the income (and the tax rate) from ordinary income to capital gain.

Tax deferral usually results from the current deduction of costs which are associated with the income which will not be reported until a later taxable year. Examples of costs which can be deducted before the related income is recognized are feed costs for animals which will not be sold until the next taxable year and costs of developing breeding animals, vineyards, and orchards.

Conversion occurs where capital and development costs have been deducted in the year incurred against ordinary income from other sources (instead of being capitalized and depreciated) and then in a later year the fully developed farm operation is sold at a capital gain.

Farm operations vary in size from small family farms to large multi-unit farms. The types of ownership in which taxpayers engage in farming vary from sole proprietorships, family partnerships and family corporations to large corporations and nationally syndicated limited partnerships with passive investors.

Farm operations are governed by special tax rules, many of which confer tax benefits on farming activities and on persons who engage in farming. Some of these special rules (such as permission to utilize the cash method of accounting) reflect an historical intent to simplify recordkeeping for farmers; other rules provide incentives for farmers to engage in land improvements and other activities. Still other farm rules are intended to correct abuses of the special farm tax rules. These corrective rules have been added (particularly in the Tax Reform Act of 1969) because in recent years high-bracket taxpayers such as business executives, doctors, lawyers, entertainers, athletes, and other investors whose principal occupations are outside of farming, have invested in farming operations that generate farm "tax losses" which they use to shelter nonfarm income.[1]

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[1] Under present law, the special tax rules available to farmers can be utilized by both full-time farmers and by high-bracket taxpayers who participate in farming as a sideline. Part-time farmers are entitled to use the special farm rules even if they are absentee owners who pay agents to operate their farming activities and regard their own participation (such as being limited partners in a nationwide syndicate) as a completely passive investment.

Where individual investors with large nonfarm incomes begin farming on a part-time basis or become passive investors in farm activities, certain deductions, which are currently allowed under the special farm rules, become particularly attractive. These deductions, which are deliberately sought by nonfarmer investors, are used to reduce their taxes on income from other sources. Furthermore, when the property stops providing tax losses and starts producing taxable income, many investors in farm syndicates dispose of their investments.

Like the outside investor, many "full-time" farmers or ranchers (that is, those individuals whose principal occupations are farming) also have other sources of income (from investments, from nonfarm employment or from nonfarm businesses) and can also utilize farm "tax losses" to reduce their taxes on their nonfarm income.

Types of Shelter Deductions

Use of the cash method without inventories

Taxpayers engaged in farming may report their income and expenses from farm operations on the cash method of accounting, without accumulating inventory costs. Farmers may also deduct the cost of seeds and young plants purchased in one year which will be sold as farm products in a later year.[2] This rule contrasts with the tax rules which govern nonfarm taxpayers engaged in the business of selling products, who must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.[3]

The special inventory exception for farmers was adopted by administrative regulation more than fifty years ago. The primary justification for this exception was the relative simplicity of the cash method of accounting which, for example, eliminates the need to identify specific costs incurred in raising particular crops or animals.

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[2] However, a farmer may not deduct the purchase price of livestock, such as cattle, which he intends to fatten for sale as beef.

[3] Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable year in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum of recordkeeping; however it does not match income with related expenses.

A primary goal of the accrual method of accounting is a matching of income and expenses. Under this method, income is included for the taxable year when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Under such a method, dedutions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to the expense and the amount can be determined with reasonable accuracy. Also under the accrual method where the manufacture or purchase of items which are to be sold is an income-producing factor, inventories must be kept and the costs of producing the merchandise must be accumulated in inventory (rather than deducted when incurred). These costs may be deducted only in the year the merchandise is sold. Regs. § 1.446–1(a)(4) and (c).

Use of the cash method without inventories gives a taxpayer the opportunity to control the timing of deductions to a much greater extent than does the accrual method.

In cases where inventory costs are deducted in a year earlier than the year in which the related income is received, such accelerated deductions create a "loss" which is used to offset a taxpayer's other income. When the income related to these accelerated deductions is realized in a later year, it will be in a greater amount than if the accelerated deductions had been deferred and matched against the income. The net effect of the acceleration of these deductions is the deferral of taxes on the taxpayer's other income.

Current deduction for development costs of business assets

The Treasury has long permitted farmers to deduct currently many of the costs of raising or growing farm assets (such as costs related to breeding animals, orchards and vineyards) which are held for the production of income. In similar nonfarming businesses (such as manufacturing), these costs generally are treated as capital expenditures and are depreciated over their useful lives.[4] Typically, the development costs of certain farm assets can be expensed. These assets are used in a taxpayer's business and may eventually be sold at a gain which is taxed at the lower capital gain tax rate. Since development costs can be deducted before the income is realized from the sale of livestock or crops, the development costs may offset a farm investor's income from other sources such as salaries, interest, professional fees, etc.

Current deduction of certain land improvement expenses

Certain provisions of present law allow specific types of capital improvements to farmland to be deducted when the taxpayer pays them. These costs include soil or water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenses (sec. 182). Similar capital expenditures in a nonfarm business would be added to the basis of the property and, since land is nondepreciable, could be recovered only out of the proceeds when the land is sold.

Capital gain treatment for sales of assets developed through deductible expenditures

Capital gain treatment is generally available on the sale of depreciable assets used in farming (as well as on the sale of the underlying farmland itself), even though these assets or land may have been developed or improved by expenditures which were deducted against ordinary income.[5] Thus, an investor or farmer can combine deductions

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[4] Thus, if a taxpayer builds a factory to be used in his manufacturing business, he is required to capitalize all the costs attributable to construction of the factory. Such costs will be recovered over the useful life of the building.

There are certain exceptions to the requirement that costs attributable to business assets be capitalized. Thus, under section 174, a taxpayer may elect to deduct currently research and experimental expenditures.

Of course, not all costs relating to development of farm assets are currently deductible. A farmer is required to capitalize costs of water wells, irrigation pipes and ditches, reservoirs, dams, roads, trucks, farm machinery, land and buildings.

[5] Under section 1231, a taxpayer who sells property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. The loss, if any, is treated as an ordinary loss. Machinery, equipment, buildings, and land used by a taxpayer in his business are examples of section 1231 property.

from ordinary income for expenses of raising the livestock or developing an orchard or vineyard with capital gain treatment when he sells the breeding animals, orchards, or vineyards. (Capital gain treatment is not available to the extent that various recapture rules of present law are applicable.)[6]

Accelerated depreciation

After breeding animals, vineyards or orchards reach maturity and are held for the production of annual crops, farmers and farm investors continue to receive tax benefits through deductions for accelerated depreciation. For example, an investor or rancher can deduct his costs of raising breeding animals (but not the purchase price) and, after purchased animals reach maturity, he can use 200 percent declining balance depreciation on the purchase price of the animals which he originally purchased for the herd.[7]

Under the Asset Depreciation Range System (ADR), the depreciable lives of farm assets are relatively short. For breeding or dairy cattle, the ADR range is 5.5–8.5 years. For breeding or work horses, the ADR class life is 8–12 years; for breeding hogs, 2.5–3.5 years; for breeding sheep and goats, 4–6 years; and for farm machinery and equipment, 8–12 years.

Accelerated depreciation under a 150-percent declining balance method is also available for new farm buildings and for the costs of purchased vineyards and orchards. The capitalizable costs of vineyards and orchards planted by the taxpayer may be depreciated on a 200-percent declining balance method.[8]

The opportunity to claim accelerated depreciation on breeding animals, orchards and other farm capital assets which have reached maturity means that farmers and farm investors can shelter not only their nonfarm income (by preproductive period cost deductions) but also part of their annual farm income from crop sales after the property reaches its productive period.[9]

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[6] This capital gain benefit has been described in the staff's overview pamphlet on tax shelters as a "conversion" of the rate of tax on income offset by the early development deductions from ordinary income to capital gain. In effect, the taxpayer's nonfarm income which is initially sheltered by accelerated farm deductions is transformed into added capital value of the farm asset and taxed as part of that value when the farm capital assets (vineyard, breeding animal, farmland, etc.) are later sold.

[7] If the rancher purchased cattle which had been used for breeding by a previous owner, the cattle can be depreciated on the 150 percent declining balance method. The offspring of purchased animals cannot be depreciated, since the owner is considered to have no cost basis in such animals. However, as indicated earlier, the cost of raising such offspring can be expensed.

[8] Under the ADR system, the useful lives of farm buildings range from 20 to 30 years. Although there are no ADR guidelines, taxpayers are currently using useful lives for fruit trees which vary from 15 to 30 years, depending on the type of trees and on different climate conditions.

[9] The latter benefit is especially valuable to farm investors who are primarily interested in the appreciation in value of the underlying ranch land on which they maintain a breeding herd, vineyard or orchard.

Many such taxpayers regard cattle as a cash crop which helps them carry the land by providing annual income to pay the underlying mortgage and real state taxes. Sheltering the cash flow from the property itself is as important to such investors as it is to the owners of a rental apartment house who use accelerated depreciation to shelter their annual rental income.

Investment credit

The investment credit is available to farmers and farm investors for personal property used in farming. Livestock (except horses) held for the production of income, orchards and vineyards, and other tangible property such as fences, drain tiles, paved barnyards, water wells and storage facilities may qualify for the investment credit.

Leverage

A taxpayer who invests directly in a herd of feeder cattle, a vineyard, or other farm property (including investments through agency relationships where the taxpayer signs a management contract with another person to operate the business on his behalf) can take advantage of leveraging to increase the amount of his deductions in a farm investment. Thus, if the taxpayer can borrow funds to pay for deductible expenses he may deduct amounts in excess of his equity capital in the farm operation.

Similarly, if an investor becomes a partner in a farming partnership, he may be able to deduct amounts in excess of his equity capital in the partnership if the partnership is financed in part by nonrecourse obligations.[10]

Tax Reform Act of 1969

In the Tax Reform Act of 1969, Congress made several changes in the tax law that were designed to reduce the deferral and conversion benefits for farm investors.

Recapture of certain farm losses

Section 1251 requires a limited recapture as ordinary income (rather than capital gain) of previous farm tax losses whenever assets used in a farming business are sold or disposed of. If, in previous years, an individual taxpayer whose nonfarm income exceeded $50,000 in a year used the cash method of accounting and incurred a farm loss larger than $25,000 in the same year, the farm loss in excess of $25,000 must be recorded in an "excess deductions account" (EDA). Any gain that would otherwise be treated as capital gain on the later sale of farm

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[10] The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations where the partnership incurs a debt, and none of the partners has personal liability (the "nonrecourse" loan), then all the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)). For example, if a partner invested $10,000 in a partnership, in return for a 10-percent profit interest, and the partnership borrowed $100,000 in the form of a nonrecourse loan, the partner's basis in the partnership would be $20,000 ($10,000 of contributions to the partnership, plus 10 percent of the $100,000 nonrecourse loan to the partnership).

assets must be reported as ordinary income to the extent of the balance in the taxpayer's EDA account at that time.[11]

A farmer who elects to report his farm operations on an accrual method of accounting (and who thus uses inventories) is not subject to the EDA rules.

This provision continues to allow a farm investor who uses the cash method of accounting to defer current taxes on his nonfarm income. It merely places a potential limit on the amount of ordinary nonfarm income which may be converted to capital gain in a future year. Thus, even where an EDA account must be maintained, this provision reduces conversion benefits but does not affect the time value of deferring taxes on nonfarm income or (in the case of depreciation deductions) on annual farm crop income.

Recapture of improvements to farm land

Section 1252 recaptures amounts previously deducted as soil and water conservation and land clearing expenses if farmland is sold within 5 years after acquisition. If the land is held for a longer period, the amount recaptured is reduced by 20 percent for each year over 5 years that the property is held. Thus, if the land is held more than 10 years, there is no recapture.

As in section 1251, this provision prevents (to some extent) farm investors from converting nonfarm income (previously offset by ordinary farm deductions) into capital gain when farmland is sold. This provision does not, however, prevent the initial deferral of taxes on nonfarm income.

Capitalization of development costs of citrus and almond groves

Section 278 contains a special rule which requires the capitalization of all amounts attributable to the planting, cultivating, maintaining or developing citrus groves incurred during the first four years after the grove was planted.

This provision was enacted as a result of a concern that tax-shelter syndicates were engaging in citrus grove operations primarily to obtain current deductions for development expenses, and that the influx of these ventures into the citrus growing industry distorted the economics of the industry to the detriment of full-time citrus growers. For example, since a portion of the syndicate's return was in the form of tax benefits, it could accept lower prices for the sale of the crop than full-time farmers.

The Revenue Act of 1971 extended this capitalization rule to almond groves.

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[11] It is immaterial what specific farm deductions produce a net farm loss. The EDA is a running account from year to year and is reduced by the amount of net farm income which the taxpayer may have in later years.

Corporations (other than Subchapter S corporations) and trusts must establish an EDA account for the full amount of their farm losses regardless of size and regardless of the amount of their nonfarm income. A Subchapter S corporation is governed by the same dollar limitations that apply to individuals, except that the corporation must include in its nonfarm income the largest amount of nonfarm income of any of its shareholders.

Lengthened holding periods for noninventory livestock

The holding period for long term capital gain treatment of cattle and horses held for draft, breeding, dairy, or sporting purposes (such as horse racing) was lengthened to 24 months (sec. 1231(b)(3)). The minimum holding period for other livestock held for such purposes was lengthened to 12 months.[12]

One effect of this rule is that many sales of "culls" from a breeding herd (animals originally held for breeding purposes but eliminated from the herd) are taxable at ordinary income rates, since many culls are sold within 24 months.

Depreciation recapture for livestock

Livestock depreciation after 1969 was made subject to recapture when the animal is sold (sec. 1245). This rule has little adverse effect on the fulltime rancher, who typically raises most of his own livestock and therefore has no depreciable cost basis in most of his animals. This rule adversely affects those farm investors, however, who purchase breeding animals out of a short-term preoccupation with accelerated depreciation deductions.[13]

Tax-free exchange of livestock

The statute was also amended in 1969 to prevent tax-free exchanges of livestock of different sexes (sec. 1031(e)). Such exchanges had previously been used to enable a rancher (or ranch investor) to build up his herd free of current tax by exchanging bull calves, most of which are not used for breeding purposes, for heifer calves which could be used to increase the size of the herd.

Activities not engaged in for profit

This provision limits the current deduction of expenses in an activity which a taxpayer engages in other than "for profit" (sec. 183). Although section 183 is not limited to farm investors, it may adversely affect high-bracket taxpayers who enter farming chiefly as a tax shelter. The rule attempts to separate activities which a taxpayer carries on principally as a hobby or for personal purposes and those which he intends to conduct as a profitmaking business. A taxpayer is presumed to be engaged in an activity for profit if the activity shows a profit in at least two of five consecutive years.[14] If an activity is found not to be engaged in for profit, expenses can be deducted only to the extent that income derived from the activity exceeds deductible interest, taxes and casualty losses.

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[12] Before the 1969 Act, the minimum holding period had been 12 months in the case of livestock held for draft, breeding, or dairy purposes and 6 months for other livestock (including race horses) used in a trade or business.

[13] Investors who purchase breeding animals as a long-term investment may escape much of the burden of depreciation recapture, because as their herd grows larger an increasing proportion will consist of raised offsping which have no depreciable basis. Eventually, most of the herd can be sold at capital gain rates with little depreciation recapture.

[14] This presumption is liberalized to two of seven consecutive years in the case of the breeding, training, showing or racing of horses.

Administrative Rulings

After a period of litigation over its authority to implement its ruling position on the deduction of prepaid feed costs, the IRS has published Rev. Rul. 75–152, I.R.B. 1975–17, 15, setting forth administrative criteria under which taxpayers on the cash method of accounting can deduct payments for feed not consumed during the taxable year of payment. In order to be deductible, the payment must not be a deposit; there must be a business purpose for the timing of the feed purchase; and the deduction must not create a material distortion of income. If any one of these tests is not satisfied, the Service will permit the deduction only as the feed is consumed by the livestock.

Impact of the 1969 Changes

Farm tax benefits have been effectively packaged and sold to high-bracket taxpayers through limited partnerships and management contracts for investments in cattle feeding, cattle breeding, tree crops, vegetable and other field crops, vineyards, dairy cows, fish, chickens and egg production. Some have, therefore, suggested that the 1969 Act changes were generally ineffective.

Table 1 shows the average farm loss reported for tax purposes since 1969 by individual taxpayers in different income brackets. This table shows that farm losses have increased as taxpayers' income levels have increased, and that this trend has remained consistent during the three years covered by the table. The fact that the largest farm losses are concentrated in income levels over $100,000 suggests that high-bracket taxpayers make use of the special farm tax rules to shelter nonfarm income.

Since deductions from tax shelters (from farming or other investments) reduce a taxpayer's adjusted gross income, Table 1 does not show the full extent to which farm losses are being used by wealthy taxpayers to shelter nonfarm income.

Table 2 shows the impact of the farm loss recapture rules of section 1251 of present law. In terms of numbers of returns, the returns which show nonfarm income of $50,000 and higher and a net farm loss of $25,000 or more have generally been less than one percent of all returns which report both nonfarm income and farm losses. In terms of the dollar amount of farm losses which are required to be placed in an EDA account, Table 2 also shows that section 1251 affects no more than 8 percent of all farm losses reported on returns which show both nonfarm income and farm losses.

TABLE 1.—NET FARM LOSSES BY SIZE OF ADJUSTED GROSS INCOME

Adjusted gross income	1970		1971		1972	
	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss
All returns—total	1, 234, 092	($2, 350)	1, 290, 203	($2, 540)	1, 171, 591	($2, 758)
Total net farm loss (thousands)		(2, 899, 513)		(3, 277, 548)		(3, 230, 956)
Under $5,000	485, 531	(2, 659)	475, 983	(2, 969)	363, 492	(3, 281)
$5,000 under $10,000	379, 947	(1, 576)	385, 338	(1, 664)	325, 492	(1, 879)
$10,000 under $20,000	284, 652	(1, 669)	327, 808	(1, 822)	354, 754	(1, 852)
$20,000 under $50,000	63, 949	(4, 202)	78, 358	(4, 087)	100, 840	(3, 894)
$50,000 under $100,000	14, 697	(9, 473)	16, 575	(9, 527)	19, 642	(9, 607)
$100,000 under $500,000	5, 012	(21, 016)	5, 787	(20, 903)	6, 941	(21, 784)
$500,000 under $1,000,000	210	(43, 143)	252	(52, 516)	301	(50, 296)
$1,000,000 or more	94	(128, 149)	102	(134, 069)	129	(170, 481)

Source: U.S. Treasury Department, Statistics of Income—Individual Income Tax Returns, 1970, 1971, 1972.

TABLE 2.—IMPACT OF SEC. 1251 OF PRESENT LAW [1]

[Money amounts in thousands of dollars]

	1969		1970		1971	
	Number of returns	Net farm loss	Number of returns	Net farm loss	Number of returns	Net farm loss
Returns showing nonfarm adjusted gross income—total	1, 128, 413	$2, 465, 610	1, 202, 914	$2, 776, 871	1, 288, 185	$3, 184, 109
Farm loss under $25,000	1, 119, 693	1, 993, 499	1, 913, 262	2, 281, 637	1, 277, 582	2, 602, 966
Farm loss $25,000 or higher	8, 720	472, 111	9, 652	495, 234	10, 603	581, 143
Effect of existing farm recapture rule (sec. 1251):						
Returns showing nonfarm income $50,000 and higher and net farm loss of $25,000 or more	5, 251	328, 833	5, 228	319, 433	5, 810	373, 752

Less $25,000 exemption per return	131, 275	130, 700	145, 250
Amount of farm losses subject to potential § 1251 recapture	197, 558	188, 733	228, 502
Percentage of total net farm loss subject to recapture	8	6. 8	7

[1] Sec. 1251 of present law requires that taxpayers engaged in farming establish an "excess deductions account" containing the portion of any farm loss above $25,000. This account must be established only if the taxpayer's nonfarm adjusted gross income exceeds $50,000 in the same year. The figures above show the effect of these limitations in relation to total net farm losses shown on all returns reporting nonfarm income.

Source: U.S. Treasury Department, Statistics of Income—Business Income Tax Returns, 1969, 1970, and 1971. The figures shown cover individuals receiving farm income and who filed Schedule F (farm income and expenses).

Deferral Shelters Generally

Present law, as applied to farming investments, focuses largely on recapturing some deductions which otherwise would be used to convert ordinary income.

From a tax shelter point of view, farm investments offer deferral of taxes on nonfarm income where deductible expenses are incurred in years prior to the years when the revenue associated with them is earned.[15] This type of deferral occurs regardless of whether the proceeds upon the later sale of the underlying farm products are taxed at ordinary income rates or at capital gain rates.

The period of deferral can be relatively short, involving expenses incurred at the end of one calendar year and sales of the farm product during the next year, or relatively long (where trees or vines take 7–10 years to reach a fruit-bearing stage). Where the deferral period is short, the transaction is often referred to as a "rollover" because the taxpayer merely delays (or rolls over) the tax on his nonfarm income from one year to the next.

Cattle feeding

Cattle feeding offers one of the best known and, until recent downturns in the farm economy, most widely used deferral shelters.

Typically, the investment is organized as a limited partnership or as an agency relationship (under a management contract) in which a commercial feedlot or a promoter agrees to act as an agent for the investor in buying, feeding and managing cattle. Cattle usually weighing 400–750 pounds are purchased and then fed special grains and other rations in order to increase their weight gain. After being fed a specialized diet for four to six months so that their weight increases to about 900–1200 pounds, the cattle are sold at public auction to meat packers or food companies.

A cattle feeding venture is typically formed in November or December, and utilizes leveraging and the cash method of accounting to permit taxpayers with income from other sources to defer taxes otherwise due on such income by deducting expenses for prepaid feed, interest, and management fees in that year. Usually the amount borrowed by the syndicate is sufficient to create tax losses which allow the taxpayer to deduct 100 to 150 percent of his own cash investment.

Income is realized in the following year when the fattened cattle are sold. At that time, the bank loans are repaid and any unpaid fees due the feedlot (or promoter) are deducted. The balance is distributed to the investors. Since feeder cattle are held for sale to customers, sales of the animals produce ordinary income. If the investors were to reinvest their profit from one feeding cycle into another one, they could theoretically defer taxes indefinitely on the nonfarm income which they sheltered originally. (To shelter nonfarm income from subsequent years, an additional investment would be required.)

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[15] As indicated earlier, where accelerated depreciation is available on breeding herds and orchards used in producing annual crops, depreciation can also shelter the investor's farm income from sales of the annual crop.

The following example shows how cattle feeding can benefit a taxpayer in the 70-percent marginal tax bracket even if the program operates at a break-even point economically.[16] Assume that taxpayer T invests in a cattle feeding venture on December 15, 1975, and that the fattened cattle are sold six months later on June 15, 1976. T's share of the deductible expenses incurred in 1975 is as follows:

Initial investment—1975

Cash investment by taxpayer		$100,000
Borrowings (nonrecourse loans)		250,000
Total funds available to buy and feed cattle		350,000
Purchase price of cattle (750 head at $280 each, not deductible)		210,000
Deductions:[1]		
Prepaid feed for 6 months	$105,000	
Prepaid interest at 12 percent for 6 months	15,000	
Management fee paid to feedlot operator	20,000	
Tax loss—1975		(140,000)
Tax deferred—1975 (70 percent)		98,000
Investor's unrecovered equity[2]		2,000

Sale of the cattle—1976

Tax results:	
Selling price of cattle[3]	$350,000
Less: basis	210,000
Ordinary gain	140,000
Tax liability (70 percent)	98,000
Cash flow:	
Cattle sales proceeds	350,000
Less:	
Loan repayment	250,000
Tax on sale (due Apr. 15, 1977)	98,000
After-tax to investor	2,000

[1] Solely for purposes of illustration, it is assumed that the amounts shown as deductions are deductible under present law in 1975. (To be deductible, each of the items must meet certain administrative tests. Thus, for example, to the extent it represents a prepayment for services to be rendered in 1976, the management fee might not be deductible in 1975.)

[2] $100,000 cash investment less $98,000 tax deferral in 1975.

[3] The selling price per head is assumed to be $466.67.

These figures show that the amount of tax which T owes at the end of the deferral period equals the amount of his previously deferred tax

[16] Solely for purposes of illustration, it is assumed that the program operates at a breakeven point. It should be noted, however, that until recent economic conditions, many syndications were structured on the assumption that three of every four breeding cycles would be profitable.

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($98,000), plus a current tax on any profit which he makes on the sale or minus a tax reduction due to any loss which he suffers.[17]

In order to show the time value to T of having deferred $98,000 in taxes on his income for one year, assume that he invests his 1975 tax saving in an industrial development bond paying 7 percent interest tax free. The tax-free interest earned over the one-year period from April 15, 1976 (when T's return for 1975 is due) to April 15, 1977 (when his return for 1976 is due) would be $6,860. Another way to express this benefit is that even though the investment broke even economically, T's average annual rate of return on the cash which he invested has been 20.38 percent.[18]

Since the EDA account rule of section 1251 of present law only recaptures capital gain on the sale of farm assets, it has no effect on the deferral benefit obtained by the taxpayer in this example. The portion of the tax loss incurred in 1975 which exceeds $25,000 would result in an addition to the EDA of $115,000 but the $140,000 of farm ordinary income reported in 1976 would reduce the EDA to zero with no adverse effect on the taxpayer.

Prepaid feed deductions.—Since may, if not most, investors in cattle feeding shelters become involved in such ventures at the end of the calendar year, deductions for prepaid feed for the cattle have been central to the creation of tax losses in that year. In recent years, the IRS has questioned deductions for prepaid feed claimed by taxpayers using the cash method of accounting. As noted above, the IRS (in Rev. Rul. 75–152) has prescribed several technical criteria and relied on its general authority to recompute a taxpayer's income if the taxpayer's method materially distorts his income. However, investors in cattle feeding shelters may still circumvent the administrative criteria in order to justify deductions for prepaid feed. It is to be noted, however, that there may be legitimate business reasons for buying feed late in the calendar year. Indeed, many who engage in farming as this principal occupation generally purchase feed in the fall of the year preceding the year during which the feed will be consumed.

It has been argued that the livestock industry needs outside capital and that the tax rules should not be changed to make the attraction of new capital more difficult during this depressed period. However, it also has been argued that, in view of present concern over funds for capital formation, this is an appropriate time to require all investment alternatives to compete for investors' funds on the basis of the earnings from the economic activity rather than earnings after special advantages from tax shelters.

Shell eggs

Another deferral shelter which gives even greater writeoffs per investment dollar than cattle feeding is the production and sale of eggs.

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[17] Some feedlot operators who promote cattle feeding programs offer to guarantee that they will purchase an investor's equity for a specified percentage of his original investment, or will reimburse him for a percentage (often as high as 80 percent) of any economic loss which the investor may suffer if cattle prices should fall. By such a "stop-loss" guarantee, the investor's risk of a declining cattle market is reduced.

[18] The annual rate of return is computed by dividing $6,860 by the sum of the amounts invested times the periods over which the amounts were invested. T is out-of-pocket $100,000 from December 15, 1975, until April 15, 1976, when his 1975 return is due. From April 15, 1976, until June 15, 1976, T has only $2,000 invested ($100,000 less $98,000 in tax reduction).

In egg shelters, the entire amount invested and borrowed can be spent on deductible items in the first year. Those items include poultry flocks. prepaid feed, and a management fee to the person who operates the program for the investors (to the extent that it is otherwise deductible). Under present law amounts paid for egg-laying hens which are commonly kept for only one year from the time they start producing are allowable deductions in the year the poultry is purchased.[19]

In one recent syndicated offering of $6 million in limited partnership interests in a shell egg operation, the partnership proposed to borrow an additional $6 million (in the form of a nonrecourse loan) and to spend the proceeds in December of the first year as follows:

Purchase of flocks	$5,400,000
Purchase of feed, medication and supplies	6,120,000
Initial management fee to general partner (not to be claimed as a deduction)	480,000
Total	12,000,000

Thus, $11,520,000 of the $12,000,000 would be paid for currently deductible items.

The availability of writeoffs of this magnitude in egg production has attracted numerous outside investors in recent years. Many full-time farmers have objected to this introduction of outside investors into egg production, arguing that shelter-minded investors have distorted the economics of the egg industry and produced instability in egg prices.[20]

Winter vegetables and other plant shelters

Shelters involving the growing of winter vegetables operate in essentially the same method as cattle feeding and egg production shelters. Invested capital is leveraged to the greatest extent possible and deductible expenses, consisting of the costs of seeds and young plants, planting and cultivation expenses, interest, rent, and management fees, are incurred in one year, while the related income is realized in margin the following year.

Similar deferral shelters can be found in the raising of horticultural plants where significant expenses are incurred in one year and the related income is realized in the following year. For instance, programs for raising azaleas and rosebushes have also been used as rollovers to defer taxes on nonfarm income from one year to another.

Deferral and Conversion Shelters

A deferral and conversion shelter offers an investor an opportunity not only to defer taxes in the manner just described but also to convert ordinary income into capital gain. The manner in which these benefits are obtained is by deducting development costs of section 1231 property (breeding cattle, orchards, vineyards, etc.) and capital gain property (farmland) from ordinary income and selling the assets

[19] Rev. Rul. 60–191, 1960–1 C.B. 78. The purchase cost of this poultry may be deducted currently if the farmer consistently does so and if the deductions clearly reflect his income.

[20] See Tax Reform Hearings, 94th Cong., 1st Sess., 213 (July 15, 1975) (Statement of John Wallace, President, United Egg Producers).

developed after holding them long enough to qualify for capital gain tax rates. Since the recapture rules which apply to these deducted development expenses are much more limited in scope than depreciation recapture rules generally, many farm operations can be structured so that there will be little or no recapture of previously deducted development costs.

Cattle breeding

Livestock breeding offers taxpayers the opportunity to defer taxes over a period of two or more years and also to convert ordinary income to capital gain.

In general, breeding operations organized to provide tax shelters rely on current deductions for prepaid expense items; current deductions for expenses of raising young animals to be used for breeding, dairy, draft or racing purposes; the investment credit; accelerated depreciation and additional first year depreciation on purchased animals and equipment; and capital gain when the mature animals are eventually sold.

Although cattle is the most widely used breeding shelter, there have been investments offered for the purchase, breeding and sale of horses, (discussed below), fur-bearing animals (such as mink, chinchilla and beaver), other types of farm animals (such as dairy cattle and hogs), and some kinds of fish or shellfish.

In the cattle breeding operation, a herd of heifers and cows is maintained by the investors. The cows in the herd are bred each year and a calf crop of 75 to 95 percent is typical. In general, most of the bull calves produced each year are sold (often to a feedlot). The rancher retains most of the heifer calves which, after about two years, are used for breeding. In addition to the bull calves sold, the venture will periodically sell heifer calves not wanted or needed for breeding operations as well as "culls" (animals which for age or other reasons are not needed or suited to the herd). The operation derives its periodic revenue from the sale of some of these cattle each year.

The cycle of a breeding herd is about 5–7 years. At the end of that period of time, the herd will normally have grown, its quality strains will have been established and most of the costs to raise the animals will have been deducted as the investors paid them. The investor can then sell his raised breeding animals and obtain capital gain with no recapture of either depreciation (since the raised animals had a zero basis) or of previous development costs (if the investor kept his annual farm losses under $25,000). Only the investor's profit on his sale of purchased breeding animals will be subject to recapture of previous depreciation deductions.

Table 3 illustrates the substantial tax benefits which a high-bracket taxpayer can obtain on a break-even cattle breeding operation conducted over a five-year period. Assume that T, a taxpayer in the 60-percent marginal rate bracket, enters into a management contract on November 1, 1975, with a professional rancher for the purchase and maintenance of a herd of cattle to be raised for breeding purposes.

The basic costs in 1975 are as follows:

Cash investment by T in 1975	$27,200
Borrowed funds	46,800
Total funds available	74,000
Purchase cost of breeding animals (200 head at $260 each)	52,000
Deductible expenses (1975): Interest, feed and other maintenance expenses, management fees	22,000

T will also have to invest additional amounts in the program as follows: 1976, $9,800; 1977, $11,000; 1978, $11,400; and 1979, $9,700.

The loan bears 9 percent interest with principal payments of $5,200 due in each of 9 years. The breeding herd is assigned a 6-year useful life for purposes of depreciation and the investment credit. First-year additional depreciation of $4,000 is taken in 1975. The herd is depreciated under a 150-percent declining balance method.

The operating results of the herd on an annual basis over five years might typically be as shown in Table 3.

TABLE 3.—*Cattle breeding program*

	1975	1976	1977	1978	1979	1980
Income:						
Steer sales [1]	0	$11,200	$9,400	$8,200	$10,600	$25,000
Sales of breeding cattle [1]	0	4,800	5,000	5,600	6,800	73,100
Less basis of purchased cattle sold	0	(7,820)	(4,830)	(2,838)	(1,901)	(6,652)
Gross income	0	8,180	9,570	10,962	15,499	91,448
Deductible expenses [2] interest, maintenance expenses and managment fees)	22,000	20,600	20,000	20,000	21,900	3,000
Depreciation:						
Additional first year depreciation	4,000					
150 percent declining balance depreciation	2,000	9,545	6,003	4,118	2,293	0

Taxable income (loss)	(28, 000)	(21, 965)	(16, 633)	(13, 156)	(8, 694)	[4] 88, 448
Cumulative taxable income (loss)	(28, 000)	(49, 965)	(66, 598)	(79, 754)	(88, 448)	0
Investment credit [3]	3, 467					
Investment credit recapture		589	485	381	156	728
Tax increase or reduction—60 percent bracket taxpayer:						
Annual effect on taxes	(20, 267)	(12, 590)	(9, 495)	(7, 513)	(5, 060)	38, 430
Cumulative effect	(20, 267)	(32, 857)	(42, 352)	(49, 865)	(54, 925)	(16, 495)

[1] This example assumes that 90 percent of the cattle of breeding age gave birth to live calves; all bull calves are sold each year; 10 percent of all heifers are culled each year; 15 percent of all breeding cows are culled each year; and that after 5 years, the entire herd is sold for an amount which enables the operation to break even.

[2] 1 yr interest and maintenance costs are prepaid annually as is 1 yr management fee except in 1980 when the cattle are sold. Maintenance expenses and management fees are based on figures circulated by a promoter. The total amount of these deductions tends to decrease annually because interest costs decrease as the loan is paid off, but this decrease is offset to some degree by the costs of maintaining an increasing number of animals. Solely for purposes of illustration, it is assumed that these expenses are deductible when paid.

[3] Useful life 6 yr. Computation of investment credit: 10 percent of ⅔ of $52,000) equals $3,467.

[4] The income realized in 1980 equals the losses suffered in prior years. Of this income, the amount which is ordinary income is computed as follows:

Income from sale of animals held less than 2 yr	$25, 000
Depreciation recapture on purchased animals still in herd	15, 952
EDA recapture (balance in EDA account from 1975 addition)	3, 000
Less deductible expenses	(3, 000)
Ordinary income	40, 952

Note: The remainder of the income attributable to the sale of the breeding herd, or $47,496, is capital gain.

Assuming that this investment qualifies as an activity carried on for profit, T would reduce his total tax liability by $16,495 (the sum of the $54,925 in tax reductions in 1975 through 1979 less the $38,430 in taxes due in 1980), on an investment which has neither made nor lost money apart from taxes. In addition, T has deferred taxes on his nonfarm income in the amount of $54,925 (of which $38,430 is only deferred and is repaid in 1980). If the amounts deferred were invested in 7 percent tax-exempt industrial development bonds until the taxes for 1980 became payable, T would have obtained a benefit of $15,589 by the time value of delaying payment of taxes on his nonfarm income. The total benefit from conversion and deferral so computed is $32,084 ($16,495 plus $15,589) on a breakeven project.[21]

This example also shows the limited scope of the farm loss recapture rules of section 1251 of present law. In the first year of this investment only $3,000 (the excess of the farm loss over $25,000) need to added to an EDA account. Although farm tax losses are incurred in four additional loss years, nothing more has to be added to the account because the annual losses are less than $25,000. On the facts of this example, the EDA rules recapture only $3,000 of the farm deductions; an additional $47,496 of development costs has been converted from ordinary income into a capital gain.

Horse operations

Although there appear to be fewer syndicated tax shelters in horse breeding and racing than in cattle feeding or breeding, two formats can be used by taxpayers seeking tax shelter in horse operations. In one format, an investor or group of investors buys mares (female horses) and conducts a breeding operation. Such an operation can take advantage of accelerated deductions, principally the current deduction of breeding fees (which are paid to another party to breed the mares to a stallion); expenses during the preproductive period of raising the foals; and accelerated depreciation (including first year depreciation) on purchased mares. The foals are in some cases retained for racing purposes or sold to dealers, usually as yearlings.

Income from such sales is ordinary income, since yearlings are by definition held for less than 24 months. However, the income is not matched with the expenses of raising the foals (since the breeding

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[21] In computing the tax benefits it is assumed that all deductions from farming in 1975 through 1979 offset nonfarm income which would otherwise be taxed in the 60-percent bracket. In computing the taxes in 1980, it is assumed that the ordinary income is taxed in the 62-percent through 66-percent brackets. The ordinary income is taxed in brackets higher than the 60-percent bracket because it is bunched in one year. It is also assumed that T has no other capital gains during 1980, so that he can use the alternative tax capital gains (a flat 25-percent rate). Further, it is assumed that investment credit is recaptured because the purchased animals were not held for 60 months.

fees and maintenance expenses were deducted in a prior year). Capital gains can be generated in a breeding operation when brood mares which have been held for more than 24 months are sold. If the mare had been purchased, any gain would be recaptured to the extent of the depreciation taken on it. If the mare sold had been born to another mare in the investor's herd, it would have no basis since all the costs incurred in breeding the mare and raising her would have been deducted previously. Consequently, under present law there would be no depreciation recapture and all the proceeds of sale would be capital gain except to the extent that the EDA rules of section 1251 apply.

In the other format, an individual (or group of individuals) buys a mare and breeds it to a stallion. The breeding fee is deducted when paid (usually upon successful breeding or upon birth of a live foal), and the costs of raising the foal are deducted when they are paid. Alternatively the investors may buy a stallion or undivided interests in a stallion and then claim depreciation deductions.

The horse is not generally ready to race until he becomes at least two years old. The income derived from racing is ordinary income, but, again, it it not matched with the costs of developing the income-producing assets. If the owner sells his race horse after or during its racing career, capital gain may be realized. An exceptionally successful horse may generate substantial breeding fees (which are ordinary income to the owner). Alternatively, the owner may syndicate interests in the horse to a group of investors who desire to obtain breeding rights to the horse (such as the syndicate in the case of Secretariat). Amounts received by the owner on such a syndication have been held entitled to capital gain treatment. (*Harry F. Guggenheim*, 46 T.C. 559 (1966)).

Orchards, groves and vineyards

An investment in an orchard, vineyard or grove involves a "tree crop" as distinct from a "field" crop such as vegetables. The list of tree crop partnerships covers virtually anything grown in an orchard or vineyard in the form of trees or vines which produce annual crops of fruits (e.g., apples and avocadoes), nuts (e.g., pecans, pistachios, walnuts), or grapes. As indicated earlier, citrus fruits and almonds are generally no longer suited to tax shelters because of the cost capitalization rule of section 278.

Tree crops offer investors both tax deferral on their nonfarm income and potential conversion to capital gain if and when the underlying vineyard is sold (or the investor sells his interest in a syndicate). During the development period of the trees or vines, the owners obtain deductions from cultivating, spraying, fertilizing and irrigating the tree or vine to its crop-producing stage. They also depreciate farm machinery, irrigation equipment, sprinkler systems, wells and fences which they install on the property. They can also obtain the investment credit; and deductions may also be available for interest, fees and some prepaid items. (In some cases, the investors lease the land on which the vineyard operation is conducted, thereby substituting deductible ground rents for nondeductible purchase price dollars.)

After the trees start producing fruit or nuts, the owners can depreciate the costs of the seedings and their original planting which were capitalized when incurred.[22] Such depreciation can partly shelter the annual crop income. Income from the crop sales is ordinary income. Capital gains is also available when the underlying land and the orchard are sold (except to the extent that various recapture rules come into play).

Table 4 illustrates the shelter available through a limited partnership formed to acquire farm land for planting and developing a grape vineyard. The crop will include wine and variety grapes which will be marketed as table grapes, crushed into wine or dried into raisins. The transaction shown is based on an actual limited partnership offering which is representative of many vineyard syndications.[23] In this offering, limited partnership shares are sold for $10,000 per unit of interest up to a maximum of 225 Units. The limited partners buy in during September of the first year and contribute a total of $2,250,000 equity. The corporate general partner (representing the promoter) contributes his property rights, including options to acquire the land on which the vineyard will be developed.

Annual profits and losses will be allocated entirely to the limited partners during the first seven years; thereafter, the annual allocation will be 10 percent to the general partner and 90 percent to the limited partners.

The partnership will purchase 1500 acres of farm land for $3.5 million, paying $500,000 down and financing the balance by a nonrecourse 9 percent purchase money mortgage. Principal payments will not begin until the fourth year of operations; in that year, principal payments will begin in annual installations of $150,000 for ten years, after which the annual installments increase under a schedule until the unpaid balance is paid in full.

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[22] Trees and vines must be depreciated over their useful lives in the business. The useful life is often determined by average industry experience. In some regions, for example, apple trees are depreciated over 18 years, fig trees over 25 years, walnut trees over 33 years, and grape vines over 20–30 years.

[23] Grape harvests are currently at record high levels, particularly in the case of wine grapes. The result is expected to be a period of price reductions for various domestic wines until demand catches up with the current oversupply. Since grapevines take about 4 years to become productive, some part of the current harvests can probably be traced to plantings by tax shelter syndicates during the early 1970's.

The partnership plans to elect the cash method of accounting and to use maximum allowable depreciation of buildings, sprinkler systems, wells, pumps, stakes and the grape vines. (Vines become eligible for depreciation and for the investment credit in the year that grapes are first produced in commercial quantities.)

Each limited partner's tax basis for his partnership interest includes his share of the nonrecourse mortgage. Table 4 shows the projected tax losses and positive taxable income during the first seven years of operations. (Grapevines generally bear commercial quantities of fruit in their third year and mature by the seventh year. In this example, since the syndicate will begin at the end of the first year, crop revenues begin in the fourth year.)

Table 4 shows how maximum advantage is taken of cash method deductions for cultivation costs as the vineyard matures from planting to full production and, after the productive life begins, of deductions for depreciation and the investment credit (which help shelter part of the annual grape revenues). During the first three years, no revenue is expected from the young vines. Growing costs, depreciation and interest deductions(magnified by leverage) create tax loses which flow through to the limited partners and shelter their income from other sources. Since the investors buy in late in the first year, they pay interest for 3 months of that year and also prepay the interest relating to year two. The projections also assume (solely for purposes of illustrations) that the expenses shown are otherwise deductible when paid. During this period, tax losses totaling $10,405 are available for each $10,000 unit.

For an investor in the 70 percent bracket, this means total tax savings of $7,283, which leaves only 27 percent of each original unit unrecovered from tax savings. The investment credit further increases the effective deferral of taxes on each investor's nonfarm income and further reduces his cash left at risk.

As grape revenues begin coming in, the venture "crosses over" to producing positive taxable income and increasing amounts of cash flow from annual sales are distributed to the partners. A further investment goal not reflected in the table is capital appreciation of the underlying land. The value of the property, with maturing vines beginning to produce major amounts of income, is expected to increase. The general partner begins to receive a percentage of net profits and the syndicate begins repaying the mortgage, thereby increasing its equity in the property.

TABLE 4.—*Grape vineyard projections*

Year	1	2	3	4	5	6	7
Crop revenue				$680,000	$1,020,000	$1,200,000	$1,400,000
Expenses:							
Cultivation costs [1]	$75,000	$260,000	$260,000	265,000	280,000	295,000	305,000
Harvesting [2]				40,000	48,000	56,000	66,000
Administrative costs [3]	8,000	20,000	20,000	20,000	20,000	20,000	20,000
Management fee [4]	42,500	42,500	42,500	42,500	42,500	42,500	42,500
Property taxes [5]	24,000	24,000	24,000	24,000	24,000	24,000	24,000
Interest [6]	337,500	270,000	270,000		256,500	243,000	229,500
Loan origination fee [7]	30,000						
Depreciation [8]	248,000	218,000	125,000	216,000	192,000	170,000	152,000
Total expenses	765,000	834,500	741,500	607,500	863,500	850,500	839,000
Taxable income(loss)—partnership	(765,000)	(834,500)	(741,500)	72,500	157,000	349,000	561,000
Taxable income/(loss) per unit	(3,400)	(3,709)	(3,296)	322	698	1,551	2,493
Tax saving per unit—70 percent bracket	2,380	2,596	2,307				
Add: Investment credit per unit [9]	298	111		356			

Cash flow:							
Crop revenues				680, 000	1, 020, 000	1, 200, 000	1, 400, 000
Less:							
Expenses other than depreciation	517, 000	616, 500	616, 500	391, 500	671, 000	680, 500	687, 000
Mortgage principal				150, 000	150, 000	150, 000	150, 000
Total	517, 000	616, 500	616, 500	138, 500	199, 000	369, 500	563, 000
Cash available for distribution—per unit				616	884	1, 642	2, 502

[1] Includes materials, supplies, and labor used in cultivating and maintaining the vines; e.g. irrigating, fertilizing, insect and pest control, weeding, pruning, tying, and vine training. Does not include cost of the vine seeds and planting the vines.

[2] Covers costs of picking, packing, storing, and selling the yearly grape crop.

[3] Includes utilities, bookkeeping and secretarial salaries.

[4] Payable to an affiliate of the general partner at $38 per acre. Includes arranging for renting tractors and other farm machinery, field supervision and "extraordinary" services such as replacing dead or unhealthy vines.

[5] Estimates used, but no effect is given to the projected value of capital improvements to the property.

[6] 1st year includes interest for ¼ of the year ($67,500) plus prepaid interest for the 2d year ($270,000). Interest shown in later years is based on the unpaid balance of the mortgage at the start of those years.

[7] Payable to the lender under the existing 1st mortgage encumbering the land.

[8] Based on capital improvements included in the purchase price of the land and to be installed by the seller. Includes installing frost control sprinkler systems, wells, tanks, reservoirs, stake, and posts. Wells, etc., are depreciated over 20 years under the 200 percent accelerated method, plus 1st year "bonus" depreciation. Sprinklers and stakes are depreciated over 15 years under the 200 percent method plus bonus depreciation. Vine depreciation begins in year 4 and is spread over 25 years under the 200 percent declining balance method.

[9] Credit claimed on various machinery and equipment and on the vines themselves when they become income-producing in the 4th year.

The investors will begin deciding whether to remain in the venture or to sell their interests. If an investor sells his interest in the partnership, or if the partnership sells the entire farm (including the land and the vines), the investor will be entitled to capital gain treatment of any gain he realizes on the land and the vines, except to the extent that recapture is required for previous depreciation (sec. 1245), cultivation expenses (sec. 1251), or soil and water conservation or land clearing expenses (sec. 1252).[24]

Ranchland leases

Individual investors and syndicates have often obtained deferral and conversion benefits by investing in ranchland which the owners then lease to a local farmer or cattleman. In this type of transaction, the investors become absentee owners of the underlying farm land but do not conduct their own farm business. Some public offerings have been structured basically as a sale-leaseback under which an existing farmer sells his farm to outside investors who then lease the land back to the farmer at a specified rental. Often, the seller /rancher is given an option to repurchase the property at the end of the lease at a price which will give the investors some profit (and capital gain).

Under this format, the investors usually use a large proportion of borrowed funds to make their initial purchase and to pay many of the deductible expenses which they will incur during the term of the lease. In this way the investors obtain the advantage of leverage: deductions greater than the amount of their own cash investment and deductions for interest prepayments (to the extent these are available under present law). During the lease, the investors typically upgrade the land and obtain special deductions for soil and water conservation expenses, fertilizer and land clearing costs. They also deduct property taxes, maintenance costs and depreciation on barns, silos, corrals, fencing and other improvements. Sometimes, the promoters of syndicates of this kind act as managers of the farm for the investors and charge a management fee, which can also be deducted when paid by the investors (provided the payment is for current services).

Under present law, the EDA rules of section 1251 may not apply at all to this transaction, since the investors might be considered to be engaged in real estate rather than in farming. The investment interest limitation in section 163(d) does not apply if the lease is not a net lease, and many ranchland leases are not net leases. (That is, the owners rather than the tenant pay most of the operating expenses.) The farm land recapture rules of section 1252 of present law might reduce the investors' capital gain if and when they sell the land, but this provision would not affect their initial deferral of taxes by means of tax losses.

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[24] The dollar limitations on the EDA rules (sec. 1251) apply separately to each partner in a partnership. Therefore, whether any partner must set up an EDA account depends on whether he has nonfarm income of more than $50,000 and whether he owns enough units so that his share of the partnership's tax losses during years 1–3 exceeds $25,000.

Timber and Christmas trees

Timber has some of the characteristics of annual crops such as vegetables and fruits, and of minerals extracted from the ground (such as gas and oil). It is unlike short-term crops, however, in that timber does not replace itself quickly; it is unlike minerals in that it does replace itself eventually and, being located above ground, it is relatively easy to find. Timber growers are permitted to claim capital gain treatment on the portion of their income which can be attributed to the increase in value of the trees while the trees are growing and before they are cut.[25]

In addition to capital gain, some of the current costs of growing timber are deductible currently as paid. These include interest on financing an investment in timber, expenses for estimating the inventory of uncut trees, for salaries and other costs of managing a tree farm (such as clearing unwanted trees and brush), and property taxes. To the extent that expenses of growing and carrying timber are deducted currently, while the income which the expenses help produce is recognized when the timber is later sold, a mismatching of income and expense occurs. This permits deferral of taxes on a timber owner's income from other sources and eventual conversion of the tax rate on such income by the capital gain rate for the grown trees. In addition, the time value of the deferral is magnified by the long period between the taking of the deductions and the receipt of the income.

The growing and selling of Christmas trees is the most frequent form of timber tax deferral shelter. Capital gain is not available if Christmas trees are not over six years old when they are cut. Under present law, however, costs for shearing, pruning, shaping, weeding and thinning trees being grown as Christmas trees have been held to be deductible as incurred.[26]

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[25] The capital gain preference for timber permits an owner to elect to treat his cutting of standing timber as giving rise to capital gain even though he has not actually sold the timber. The gain is measured by the difference between the cost of the timber cut and its fair market value on the first day of the taxable year in which it is cut (sec. 631(a)). Any amount realized in excess of the fair market value, such as from converting the cut timber to logs, or resulting from increase in value after cutting, is taxed as ordinary income.

[26] See, e.g., Daniel D. Kinley, 51 T.C. 1000 (1969), affirmed 70–2 U.S.T.C. Par. 9462 (2d Cir. 1970); Rev. Rul. 71–228. 1971–1 C.B. 53.

5. OIL AND GAS

General

In the typical drilling fund, an oil company or promoter (often a corporation) forms a limited partnership with itself as the general partner. It then solicits additional equity investments in the partnership from outside parties, who become limited partners. This capital, and in some cases borrowed funds, is used to acquire the working or operating interest in prospective oil and gas properties and to engage in exploratory drilling on these properties. Any borrowed funds are usually obtained on a nonrecourse basis, that is, none of the partners are personally liable for this debt and the lender must seek repayments from specified partnership assets, such as any oil and gas reserves discovered as a result of the exploration.

The principal features of oil and gas tax shelters include:

(1) the immediate deduction of intangible drilling and development costs;

(2) the use of leverage through noncourse loans so that the limited partners are able to deduct expenses in excess of their actual equity investment in the partnership without being personally liable on the loans; and

(3) conversion of ordinary income into capital gains.

Types of Shelter Deductions

Rapid writeoff of expenses; intangible drilling costs

Under present law, a partner (including a limited partner) is required to take into income his distributive share of the partnership's income or losses (sec. 702). Generally, the partner's distributive share is determined under the partnership agreement (sec. 704). Thus, the partner may deduct from his income all of the losses of the partnership which are allocated to him under the partnership agreement.

In the case of the oil and gas drilling partnership, the most important (by far) of the expense items which generates large immediate losses is the deduction for intangible drilling and development costs. The intangible drilling deduction is specifically allowed as an option for oil and gas wells under section 263(c). Intangible drilling expenses include amounts paid for labor, fuel, repairs, hauling and supplies which are used in drilling wells, clearing of ground in preparation for drilling, and the intangible costs of constructing certain equipment such as derricks, tanks, and pipeline which are necessary for drilling. But for the statutory election to deduct these costs, they would, in the case of a successful well, be capitalized over the life of the well and, in the case of a dry hole, be deducted at a time the dry hole is completed.

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The Service has ruled, in Rev. Rul. 68–139, 1968–1 C.B. 311, that a limited partnership may earmark a limited partner's contribution to expenditures for intangible drilling costs, thereby allowing the allocation of the entire deduction to the limited partners (if the principal purpose of such allocation is not the avoidance of Federal taxes). Generally, in the case of a drilling partnership, all deductible items are allocated to the limited partners so that they can receive the maximum immediate write-off.

In another ruling in this area, Rev. Rul. 71–252, 1971–1 C.B. 146, the Service has ruled that a deduction may be claimed for intangible drilling costs in the year paid, even though the drilling was performed during the following year, so long as such payments are required to be made under the drilling contract in question.[2]

Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705). Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, where the partnership incurs a debt, and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)). The use of leveraging through nonrecourse loans has been reduced because of Internal Revenue Service rulings that nonrecourse loans are to be treated as equity investments where the lender is the general partner of the partnership or is a third party who has a profits interest in the property (Rev. Ruls. 72–135 and 72–350, as discussed above in the "Overview," in part A). Nonetheless, leveraging has been continued at least in drilling funds that are not syndicated. Moreover, there is no certainty that the position of the Service will ultimately be sustained by the courts.

It should be noted, however, that third-party nonrecourse financing is seldom used in exploratory (as opposed to developmental) drilling.

Conversion of ordinary income into capital gain

The interest of the lessee in an oil or gas property has been held to be "real property used in the trade or business" within the meaning of section 1231 (Rev. Rul. 68–226, 1968–1 C.B. 362). The gain from the sale or exchange of such property will generally be treated as long-term capital gain (except to the extent of any depreciation recapture and assuming a 6-month holding period) unless the property is considered to be "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." [3] An interest in a partnership is also generally treated as a capital asset (sec. 741).[4]

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[2] See also Rev. Rul. 71–579, 1971–2 C.B. 225.

[3] Under section 1231, a taxpayer who sells property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. The loss, if any, is treated as an ordinary loss.

[4] This would be the result except to the extent of any unrealized receivables, substantially appreciated inventory, and depreciation recapture.

Thus, if the drilling is successful and the partnership disposes of its interest in the mineral property, or the limited partner disposes of his interest in the partnership, the income realized by the limited partner on his drilling investment would generally be treated as capital gain income.[5] (Many limited partnership agreements provide that the limited partner may have the right to sell his interest to the general partner under certain circumstances and subject to certain conditions.) In this way, the partner would be able to convert the ordinary income deductions based on his contributions to the partnership, as well as any leveraged amounts, into capital gain.[6]

If, however, the drilling is unsuccessful, no interest would be sold at a gain and no conversion of ordinary income to capital gain would take place to the extent of the partner's investment. But if the partnership is financed in part through nonrecourse loans, the nonrecourse debt would become worthless (because no oil or gas is found), which generally constitutes income to the partnership when the debt is foreclosed. This income is treated as capital gain from the "sales" of the mineral property (see *Commissioner* v. *Rogers*, 37 B.T.A. 897 (1938), aff'd. 22 AFTR 1129 (9th Cir., 1939)), and retains this character when it is passed through to the partner (sec. 702(b)). Thus, even in the case of unsuccessful wells, ordinary income deductions are converted into capital gains to the extent of any leveraged amounts.

Operation of Shelter Provision

The material below discusses some of the issues commonly raised with respect to tax shelter investments in oil and gas.

In general

Many of the elements which apply to tax shelters generally also apply to the oil and gas shelter.

Deferral of tax exists here, primarily because of intangible drilling costs, which are immediately deducted (under sec. 263(c)) even though the income attributable to those expenses is not realized until later years.

The use of leverage (i.e., nonrecourse loans) in the drilling fund situation expands the benefits of deferral by allowing the limited partners to claim Federal tax deductions for amounts in excess of their economic investment. This result also alters the economic substance of the transaction by permitting the taxpayer to deduct money which he has neither lost nor placed at risk.

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[5] If the loan were repaid out of the partnership income, each partner would take into income his distributive share of the amounts used for repayment; the partner's basis would not be affected. (The partner's basis would increase to the extent that his distributive share of the partnership income was used for partnership purposes, such as repayment of the loan, but his basis would decrease in an equal amount because his share of the nonrecourse partnership liability was being reduced by the repayment.)

[6] There is an argument that the intangible drilling costs deducted by a taxpayer might be subject to recapture under present law under the tax benefit theory. For example, in Rev. Rul. 61–214, 1961–2 C.B. 60, the Service rule that certain costs of tangible property, such as tools and supplies, were to be recaptured as ordianry income, even though this property was sold as a part of section 337 tax-free liquidation transaction. However, it does not appear that there has been any use of this approach in the area of intangible drilling costs.

The conversion of ordinary income into capital gain also occurs in connection with the oil and gas shelter. The deferral of tax discussed above resulting from the deductions (including leveraged deductions) against ordinary income can become a permanent tax savings since most (or all) of the income which a taxpayer receives from the transaction will be treated as long-term capital gains. The taxpayer may, in effect, cut his taxable income in half, even where he has suffered no economic loss.

It is not clear, even under present law, that taxpayers are entitled to all the deductions which are sometimes claimed in connection with the oil and gas drilling funds.[7] As a result, many participants in these shelters may be taking deductions which will later be disallowed by the IRS. As a result of this fact, some have argued that unsophisticated investors may be lured into investments because of the hope of tax benefits which may never be realized.

Whether or not the tax benefits are realized, some believe that investments marketed almost exclusively for their tax advantages, rather than on the basis of the underlying soundness of the investment itself, can distort the workings of the free market system and may tempt taxpayers to invest their money in unwise adventures. This is said to occur because, while it is possible for certain taxpayers to make money (due to the tax advantages) even when the drilling venture loses every cent (see example below), there are other taxpayers who find themselves economically worse off as a result of these investments.[8]

Example

Assume that A, whose marginal tax rate is 70 percent, is one of 8 individuals who invest $100,000 each for a 10 percent profits interest in the XYZ drilling syndicate, a limited partnership under State law. The general partner, G, who will manage the drilling venture, is entitled to 20 percent of the XYZ profits. The XYZ partnership agreement allocates all noncapital costs and expenses solely to the limited partners. XYZ obtains a nonrecourse loan for $800,000, in return for a security interest in its working rights to mineral properties. In the same year it was set up, XYZ uses the available cash ($1,600,000) to drill oil and gas wells.[9]

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[7] For example, there may be questions as to whether nonrecourse loans made to the partnership should be treated as debt (which may be used to increase the basis of the limited partners) or an equity investment by the lender (which may not be so used). Also, it is the IRS position that syndication costs may not be deducted, but these expenses are sometimes claimed as a deduction in connection with this shelter.

[8] This fate does not necessarily befall the syndicators, who generally charge a management fee and charge the costs of syndication to the limited partners. Some syndicators contribute capital to the venture, while others do not contribute any significant amount. If the venture is successful, the syndicator generally has a substantial profits interest. Even those syndicators who do contribute capital are typically involved in a number of ventures, which gives the syndicator a degree of risk spreading that the limited partners do not necessarily have.

[9] The deduction may also be taken, in the case of a cash basis taxpayer, if the partnership enters into a binding written agreement to have the drilling done in the following year (so long as the payments are required to be made under the contract), under the doctrine of the *Pauley* case, 63–1 USTC 9280 (S.D. Cal.); Rev. Rul. 71–252, 1971–1 C.B. 146.

A, as a result of these transactions, has the following tax consequences: A's basis for his partnership interest consists of his equity, $100,000, plus his share of the non-recourse loan to the partnership, which is 10 percent of $800,000 ($80,000). XYZ, having expended all $1,600,000 of its capital on drilling costs, has a deduction of $1,600,000,[10] which is allocated pro rata among A and his fellow limited partners.

A may deduct his share of the drilling expenses, $200,000 (one-eighth of $1,600,000), to the extent of his basis of $180,000. (The remaining $20,000 is available for future deductions if A's basis in the partnership should be increased.) This deduction will save him $126,000 in taxes. Since he invested only $100,000, the upshot of these transactions is a net saving of $26,000. A, of course, retains his interest in the drilling syndicate.

Assume that in a later year it is determined that all the wells are worthless, the property is foreclosed, and this results in a taxable disposition. A would realize a capital gain equal to his share of the partnership liability ($80,000) in excess of his basis (zero). Since this gain is taxed as capital gain, his tax would be $28,000.[11] Thus even if this taxpayer invested in a completely worthless venture, his participation would cost him only $2,000. (The rest of the cost would be borne by the Government.)

But this does not take account of the value of the deferral which the taxpayer has received. Even one year's deferral of $126,000 in taxes, at a 7 percent interest rate, would be worth $8,820. In other words, the taxpayer would be dollars ahead even if the drilling partnership were completely unsuccessful.[12]

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[10] Some fraction of this amount might be expended for tangible drilling costs, such as drilling tools, pipe, casing, etc., which would have to be capitalized. In many partnerships, the general partner will put up some capital, and the partnership agreement provides that the capital items will all be charged to the general partner, in order to give each limited partner a full immediate write-off that is at least equal to his basis.

[11] This ignores the possible impact of the minimum tax (sec. 56) and the alternative tax on capital gains (sec. 1201(d)).

[12] To some this may appear to be an extreme example, since the drilling fund was leveraged, and the taxpayer was in the highest bracket. However, the example assumed that the taxpayer obtained only one year of deferral (whereas longer periods of deferral are not uncommon, and the value of the deferral obviously depends on the length of the deferral period). Likewise, the shelter in the example was leveraged at a one to one ratio (one dollar of leverage for each dollar of investment) but higher ratios of leverage are sometimes attempted.

6. MOVIE FILMS

General

Motion picture shelters generally have two basic forms. In one format, a limited partnership is formed to purchase the rights to an already completed film. The purchase price is heavily leveraged and the partners claim substantial depreciation deductions. The principal features of the shelter are deferral and leverage; also the partners also claim the investment credit with respect to the film. This type of deal is sometimes referred to as a "negative pick-up" or "amortization purchase" transaction. Many of these transactions involve foreign-produced films.

In the second type of format, the limited partnership is formed as a production partnership. The production partnership enters into an agreement with a studio, with a distributor or with an independent producer to produce a particular film. The production partnership uses the cash method of accounting and writes off the costs of production, as they are paid. The partnership is heavily leveraged and significant costs are paid with borrowed funds. The principal elements of this form of motion picture shelter are deferral and leverage. This type of shelter is sometimes referred to as a "service company."

Film Purchase Tax Shelter

Description of the Shelter

In this type of transaction, a syndicate of investors, usually formed as a limited partnership, purchases a completed film for a cash payment plus a nonrecourse note given to the seller (often falling due within a range of 7 to 10 years). It is not uncommon for the leverage factor in this type of transaction to be 3 or 4 to 1 (i.e. 3 or 4 dollars of borrowing for each dollar of equity investment) and sometimes even higher. The partnership usually turns over the function of distributing the picture to a major studio-distributor (which is sometimes the same person who sold the film to the partnership), which makes prints, arranges showings and handles advertising and promotion in return for a percentage of the gross receipts.

The income from showing the film is divided many ways. A substantial share goes to the theater owners who show the film locally. The distributor receives a distribution fee and, in addition, it is common for the producer and/or the stars of the film to have rights to a share of the income. The limited partnership, as the owner of the film, has the "negative interest" which is also a right to a certain share of the gross receipts.

As indicated above, however, this negative interest is often heavily mortgaged. The nonrecourse note is to be liquidated from the film's receipts. Some agreements provide that the nonrecourse note must be liquidated first, before the limited partners recover any of their own equity capital or realize a profit. Other arrangements provide for some form of pro rata pay off, under which each dollar allocated to the negative interest is divided between the noteholder and the limited partners on some predetermined basis.

The shelter aspect occurs because of very rapid depreciation of the cost of the film (which, of course, includes the basis which is attributable to leverage).[1]

Type of Deduction for Film Purchase Tax Shelters

A. Rapid write-off expenses.

Under present law, a partner (including a limited partner) is required to take into income his distributive share of the partnership's income or losses (sec. 702). Generally, the partner's distributive share is determined under the partnership agreement (sec. 704). Thus, the partner may deduct from his income, generally, all of the losses of the partnership which are allocated to him under the partnership agreement. In the case of the film-purchase shelter, the most important of these expense items, is the deduction for depreciation which is computed under the income forecast method described below.

B. Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705). Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, where the partnership incurs a debt, and none of the partners have personal liability (the "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)).

Generally, in this type of transaction, most or all of the profits interest in the partnership (and therefore most of the leverage) is allocated to the limited partners.

C. The income forecast method

Motion pictures are usually depreciated on the "income forecast" method. (Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62.) This method is used because, unlike most other depreciable assets, the useful life of a motion picture is difficult to ascertain. Under the income forecast method, the taxpayer computes depreciation by using a fraction, the numerator of which is the income received from the film during the year and the denominator of which is the total estimated income which the film is expected to generate over its remaining lifetime. This fraction is then multiplied by the basis of the film. For example, if the taxpayer has a basis of $500,000 in his interest in the film, the income from the film through the end of the first year is

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[1] Although relatively insignificant, the deduction of syndication fees is also a factor in some of these shelters.

$750,000, and the total estimated income from the film over its lifetime is $1,000,000, the taxpayer would be allowed to depreciate 75 percent of his basis, or $375,000. (If the income forecast increases or decreases as a result of changed circumstances, this is taken into account for later periods. Thus, in the second year, depreciation under the income forecast method might be based on an income forecast denominator which was more or less than the amount used for the first year.)

D. Depreciation recapture

There is some question as to whether a movie film in the hands of a limited partnership, such as those described here, would constitute a capital asset (within the meaning of sec. 1221), or "property used in the trade or business" of the taxpayer which is neither "inventory," nor "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (within the meaning of sec. 1231).[2] There is certainly an argument that where the limited partnership owns a single film, which it did not produce, and which it holds for a period of years, such property should be viewed as a section 212 investment,[3] or as 1231 property which is not inventory and is not held "primarily for sale." On the other hand, the Service, in applying these provisions to movie films, has applied the primarily for sale principle on a broad basis which might well reach many of the fact situations involved in these shelters. (See Rev. Rul. 62–141, 1962–2 C.B. 182).

If the film is not a capital asset (or section 1231 property), any income received with respect to the film would be ordinary income. Assuming that the film is found to be a capital asset, income realized on the sale or exchange of the film would be subject to the depreciation recapture rules of section 1245. Thus, the proceeds of the sale in excess of the taxpayer's adjusted basis would constitute ordinary income to the extent of any depreciation previously allowable with respect to the film.[4]

Even if the film is not sold, there should eventually be recapture of the depreciation attributable to the nonrecourse note. If the film is successful and the loan is repaid out of the partnership income, each partner would take into income his distributive share of the amounts used for repayment; the partner's basis would not be affected. (The partner's basis would increase to the extent that his distributive share of the partnership income was used for partnership purposes, such as repayment of the loan, but his basis would decrease in an equal amount because his share of the nonrecourse partnership liability was

[2] Under section 1231, a taxpayer who sells certain property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the net gain, if any, is treated as capital gain. The net loss, if any, is treated as an ordinary loss.

[3] Section 212 permits the deduction of expenses paid or incurred for the production of income, or for the management, conservation or maintenance of property held for the production of income.

[4] If the partner sold his interest in the partnership, the depreciation would be recaptured as an "unrealized receivable" under section 751.

being reduced by the repayment.) If the film is not successful and the nonrecourse debt becomes worthless, this generally constitutes income to the partnership when the debt is foreclosed, because the foreclosure is treated as a "sale" of the movie film, (See *Commissioner* v. *Rogers*, 37 B.T.A. 897 (1938), aff'd 22 AFTR 1129 (9th Cir., 1939)), which is subject to the recapture rules of section 1245.[5]

How the Shelter Works

As a practical matter, there is relatively little sheltering effect where the total estimated revenues to be received from the film exceed the purchase price paid for the film.[6] Where the projected income stream of the film is less than the purchase price, and depreciation is based on the income forecast method, the depreciation deduction claimed by the limited partners will exceed the amount of income from the film which the partners are required to recognize.

Tax shelter benefits are the greatest where the limited partnership "pays" more for the film than its economic value. Much of this payment, of course, is in the form of a nonrecourse note, the payment of which is dependent on the receipts from showing of the film.

Assume, for example, that prior to commercial release of a completed film, the limited partnership pays the production studio $1,000,000 for the film, consisting of $200,000 cash and a 10-year nonrecourse note of $800,000. After the film is released, it becomes apparent that it will not be successful and will not generate box office receipts equal to the purchase price paid by the investors. The film is reappraised and it is now determined that its estimated income over its lifetime will not exceed the $200,000 cash down payment. If this reappraisal proves accurate the depreciation and income which would be passed through to the limited partners over the following 10 years would be as follows:

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[5] Likewise, if the partnership discontinues its operations, this should constitute a constructive distribution of the partnership assets (including, for this purpose, the unpaid portion of the nonrecourse note) to the partners, which in turn triggers the recapture rules of section 1245. However, it is by no means clear that all taxpayers follow sound tax accounting principles at this point in the shelter transaction, and much of this income may be "forgotten". When this occurs, it is difficult for the Internal Revenue Service to detect unless there is a field audit.

[6] This is easiest to illustrate in a case where the income stream is greater than the purchase price. For example, if the film is purchased for $2 million (and has this as its basis), but has an estimated income stream of $4 million, $3 million of which is earned during the first year, the result would be as follows. The partners would be allowed to take 75 percent of their $2 million basis as depreciation in the first year under the income forecast method (or a $1,500,000 deduction). However, the film would be also generating $3 million of income which the partners would have to recognize. Thus, the net tax effect would be positive taxable income to the partners of $1,500,000. Where the purchase price of the film and its estimated income stream are exactly equal, the depreciation deduction and the amount of income from the film should exactly offset each other.

	Percent of revenue	Revenue	Deprecia-tion	Tax loss
Year:				
1	80.0	$160,000	$800,000	($640,000)
2	10.0	20,000	100,000	(80,000)
3	5.0	10,000	50,000	(40,000)
4	2.5	5,000	25,000	(20,000)
5	1.0	2,000	10,000	(8,000)
6–10	1.5	3,000	15,000	(12,000)
Total	100.0	200,000	1,000,000	(800,000)

At this point, the investors might default on the note, and the partners would have to recognize $800,000 of income.[7] This $800,000 is the same as the cumulative deductions which they had taken over the ten year period. Since the major portion of these accelerated deductions would have occurred in the early years, the value of the deferral on these amounts would be substantial. (For example, a $640,000 loss was generated in the first year).

Assuming that the taxpayer was in the 70-percent bracket, a $640,000 loss would save him $448,000 in taxes. At a 7-percent rate of interest, compounded annually for 9 years, the value of the deferral on the first year's loss alone is about $375,000.

The total income from a film might be less than the purchase price paid by the investor. This can occur for one of several reasons. Estimating the probable income stream from a motion picture is difficult. Generally films are purchased before they are distributed to the public. There are ways of estimating the income stream, even at this point (for example, by examining the results of private screenings, the distribution contracts, and the promotional efforts of the distributor), but there is also a highly subjective element involved, and it is possible to make good faith mistakes in valuation which can be substantial.[8]

Some believe that the necessarily subjective process of valuation presents an abuse potential which is sometimes exploited. This belief is based on the premise that, while the limited partners have an arms-length interest in seeing to it that their down payment is not excessive in view of the actual value of the film. They have little to lose, however,

[7] In most cases, all, or a substantial part of the $200,000 income from the film would have been used to reduce the amount of the nonrecourse note. Thus, the amount which the partners' would have to take into income would generally be less than $800,000. Economically, however, the deferral on the $800,000 of accelerated deductions would end at this point, because the combination of the amount which the partners would be required to take into income, plus their real economic loss on the $200,000 of equity investment, would total $800,000.

[8] Another factor which may help to explain a disparity between the purchase price paid for a film, and a lower "income forecast" is that taxpayers are not required to include projected income from television rights as part of the income forecast, if the film is American made, and no television contract has been entered into. Rev. Proc. 71–29, 1971–2 C.B. 568. But, in many cases, the potential revenues from television rights are taken into account in determining the purchase price of the film.

in paying an inflated sales price which is represented only by a nonrecourse note. Although an inflated sales price will reduce the partner's ultimate profits, should the film prove to be successful, many of the investors of this type of limited partnership are alleged to be far more concerned with immediate tax benefits than with the speculative possibility of profits which may or may not materialize in the future.

From the standpoint of the seller, it can afford to be generous in terms of the size of the note it is willing to take. If the film is successful, the note will be paid and the seller's profits will be relatively large; if the film is a failure, the seller still has the cash down payment in the bank, plus whatever amounts on the note have been paid off.

Thus, according to this line of argument, both parties to the transaction may have little incentive to place a low value on the film at the time it is sold to the limited partnership, to the extent that the purchase price is represented by the nonrecourse note. On the other hand, as indicated above, the tax advantages which can result from a high overvaluation of the film can be substantial.

Questions Under Present Law

As explained above, film purchase transactions produce substantial tax shelter benefits only where the purchase price of the film (including nonrecourse indebtedness) exceeds its economic value.

There is a substantial question under present law whether taxpayers in a film-purchase shelter are legally entitled to claim depreciation which is based on nonrecourse indebtedness where the "purchase price" of the film is in excess of the income pre cost on the film.

While the authorities in this area have not been uniform, there are several cases which have disallowed the depreciation deduction based on nonrecourse liability where there was no substantial prospect that this liability would be discharged. In *Leonard Marcus*, 30 T.C.M. 1263 (1971), the court held that where the taxpayer purchased two bowling alleys for a 5 percent down payment, with a 20-year nonrecourse note for the balance, the taxpayer could depreciate only the basis represented by his down payment, and that the note could be taken into account for purposes of increasing the taxpayer's basis only to the extent that payments were actually made. The court held that the liability represented by the note was too "contingent" to be included in basis until payments were made.[9]

In *Marvin M. May*, 31 T.C.M. 279 (1972), the Tax Court held that a transaction in which the taxpayer purchased 13 television episodes for $35,000, and obligated himself to pay an additional $330,000 on a nonrecourse basis was a sham, because this amount was far in excess of the fair market value of the films and there was no realistic prospect (or intention) that the debt would ever be paid. Therefore the Court disallowed the depreciation deduction claimed with respect to the film. The facts of *May* were rather extreme, however, because the taxpayer apparently made no effort to ascertain the value of the films before his "purchase," and there were a number of other factors suggesting

[9] In *Marcus*, the 20-year term of the note was substantially in excess of the useful life of the bowling alleys.

that the transaction was not *bona fides*. See also, Rev. Rul. 69–77, 1969–1 C.B. 59.[10]

It would seem that some of these same principles could often be applied in the case of a film purchase shelter, where the purchase price of the film consists largely of nonrecourse indebtedness and substantially exceeds the film's income forecast. However, to date at least, the uncertainties of present law have not deterred the use of this type of shelter, perhaps because each court case turns on its own facts, the results of litigation in this area have not been uniform, and taxpayers and their counsel who take an interest in tax shelters tend to be optimistic.

The Production Company Transaction

Description of the Shelter

In this type of arrangement, the limited partnership enters into an agreement with a distributor to produce a motion picture. Generally the distributor's requirements in connection with the film are spelled out in some detail, and the distributor will generally retain some rights of quality control including, for example, the right to request added scenes and retakes. The limited partners typically have no knowledge of the motion picture business and the production services are managed by the general partner or an individual producer who is (directly or indirectly) pre-selected by the distributor. (In some cases, the partnership subcontracts the actual production work to a production company owned by an independent producer.)

The financing for the production costs of the film comes from capital contributions by the limited partners and a substantial nonrecourse loan, which may be made by a bank, but is guaranteed by the distributor. It is common for partnerships of this type to be leveraged in a ratio of 3 or 4 to 1, and higher ratios of leverage are not unheard of.

The limited partnership does not have any ownership interest in the film. The total fee which the partnership receives generally equals the cost of making the film plus a potential profit. Frequently, there is a guaranteed or "fixed fee" which equals the bank loan and must be paid over to the bank as soon as the partnership receives it. There is also a contingent portion of the fee which is based on a percentage of the income from the film. Often there is a ceiling on this contingent fee (in other words, a maximum fee which will not be exceeded even if the film is very successful). Sometimes the total fee is payable over a period of 6 or 7 years after which the investors' rights terminate.

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[10] As indicated above, under the partnership provisions, the partner may add to his basis in the partnership his share of the nonrecourse liabilities. However, section 752(c) provides that "a liability to which property is subject" shall be considered as a liability of the owner of the property "to the extent of the fair market value of such property . . ." Since the "fair market value" of a movie film can hardly be in excess of its projected lifetime earnings, this suggests that a partner's basis cannot include his share of nonrecourse indebtedness to the extent that this indebtedness (plus the partners' down payment) exceeds the income forecast for the film.

The partnership elects the cash method of accounting, and deducts the production costs of the film as they are paid. Naturally no income is generated during the production period because the film has not been completed.

When the film is distributed, the partners are required to recognize their respective shares of the partnership income, including the income which is used to discharge the nonrecourse loan. However, there has been a period of deferral which varies from deal to deal, depending on the fee schedule provided under the agreement with the distributor and, to some extent, on the success of the film.[11] It is common for the payments under the contracts to be spread over a period of about 6 or 7 years, with the larger payments coming at the end, to maximize the tax benefits of deferral for the limited partners.

Since the partnership will have deducted its expenses in the first year (instead of capitalizing them), it will have no basis in the fee payments when they are received, and the entire amount will be taxable income which will be passed through to the partners. (If the partnership has already begun producing another picture, the deductions from the new picture may shelter all or part of the income from the first picture.) [12] Eventually, all of the deductions claimed by a partner in excess of his actual investment will have to be included in his income, but the benefit of deferring his tax liability for a lengthy period of time can be considerable.

The "service company" format thus differs from the "negative pick-up" transaction because the investors do not own the completed picture. The distributor or the independent producer owns the picture and claims depreciation and the investment credit.[13]

Example.—In 1975 an independent producer, P, owns a screen play which he wants to develop into a film. P interests D, a major studio-distributor, in guaranteeing part of the financing of the project in return for exclusive distribution rights to the film. The budget for the picture is $2 million. P obtains the services of a promoter who solicits investors for a limited partnership (in which the general part-

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[11] The possibility that the limited partners will realize an economic profit on their investment may depend to a great extent in the success of the film. However, the success or failure of the film does not determine the success of the shelter to nearly the same extent as in the film purchase shelter type deal. This is precisely because the length of the period of deferral for the production company partners depends on the fee payment schedule, which can be controlled under the contract. Generally part of the fee payments are contingent on profits, but are not to exceed a stated amount for a given year, regardless of film's profitability. (As discussed above, in the film purchase deal, if the film is successful, there should be no shelter effect from the transaction because income should equal or exceed the accelerated deductions.)

[12] Some recent syndicates have combined investments in completed pictures with production of new pictures. In this way, excess depreciation from the completed picture can effectively shelter income received under the production contract.

[13] Another variation of this shelter (although not as widespread) is the film distributor partnership. In this shelter, the partnership also does not own an interest in the film. The partnership obligates itself to distribute the film and writes-off the costs of distribution. Deferral occurs because the partnership's income from its distribution services is not realized until later years.

ner is a corporation formed by the promoter). Ten individuals, each in the 60 percent tax bracket, agree as limited partners to contribute a total of $500,000 to the capital of the partnership. The partnership then obtains a nonrecourse loan for the balance of the budget cost (secured by the partnership's right to payment and by a guarantee from D). The project is thus financed as follows:

Investors' equity (25 percent)	$500,000
Bank loan (75 percent)	1,500,000
Total cost	2,000,000

The limited partnership contracts to make the picture from the screen play and to deliver the negative to P. Simultaneously, P contracts with D to deliver the completed film to D. The partnership agrees to deliver the completed film to D on or before January 1, 1976, and the partnership will receive $3 million in installments as follows:

A fixed amount of $1,500,000, payable without regard to box office receipts, as follows: $1,200,000 on January 1, 1977, and $300,000 on January 1, 1978;

30 percent of $2,750,000 of D's grosses after D first grosses $2,500,000 from the film;

25 percent of the next $2,700,000 of D's grosses.

The fixed fee is earmarked to be paid over to the bank when it is received by the partnership. (The partnership is entitled to interest on the fixed fee at the same rate it must pay on the bank loan.) The partnership's rights to payments terminate in all events after seven years. Net profits (after payment to the service company) are divided equally between P and D.

The partnership elects to use the cash method of accounting and hires the necessary personnel. The picture is made within its budget, all of which is expended during 1975. On January 1, 1976, the completed film is delivered to the distributor. Assume that the movie is successful and that the investors receive the full profit they expect. The partnership's tax and cash flow results are expected to be as follows (if the production cost deductions are upheld):

	Income	Deductions	(Tax loss)/ income	Tax savings/ (liability) 60 percent bracket	Cash flow: positive (negative)
1975	0	$2, 000, 000	($2, 000, 000)	$1, 200, 000	[1] $700, 000
1976					
1977	$1, 200, 000		1, 200, 000	(720, 000)	[2] (720, 000)
1978	600, 000		600, 000	(360, 000)	[3] (60, 000)
1979	525, 000		525, 000	(315, 000)	[4] 210, 000
1980	375, 000		375, 000	(225, 000)	[4] 150, 000
1981	300, 000		300, 000	(180, 000)	[4] 120, 000
Total	3, 000, 000	2, 000, 000	1, 000, 000	(600, 000)	400, 000

[1] Tax saving in 1975 less cash invested ($500,000).
[2] Entire amount of income paid over to bank on loan.
[3] $600,000 income less $300,000 paid to bank and $360,000 in current tax liability.
[4] Income less current tax liability.

If the deductions are upheld, the partnership will have written off all of its production costs (including all the investors' equity) in its first year of operations. The investors will have deducted $4 for each $1 they invested. In the 60 percent tax bracket, this means that each of the ten investors has deferred $120,000 in current taxes on his other income. Having put up $50,000 in cash, each investor has effectively recovered all of his cash investment and also obtained use of an extra $70,000 of tax dollars which he would otherwise have paid to the Treasury.

Type of Deduction for "Production Company" Shelter

The basic principles of partnership tax law which were discussed above in connection with the film purchase shelter also apply to production company shelters. These include the use of the partnership form to allow the limited partner to take into income his distributive share of the partnership's income or losses (which are generally determined under the partnership agreement). The amount of loss which the partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership, which includes not only his own contributions to the partnership, but also his share (which is based on his profits interest in the partnership) of any nonrecourse debt which the partnership has incurred. However there are several questions of law which arise only in connection with the "production company" type shelter.

A. Cash method of accounting

Obtaining tax deferral through a production company transaction depends on whether the partnership can properly deduct its costs of producing the film as it pays them. This in turn depends on whether proper tax accounting practices permit the partnership to treat these costs as an item of expense or require the partnership to capitalize these expenditures and amortize them over the life of the asset. (In this case, the asset is the partnership's rights under the contract with the distributor-owner of the film.)

Under present law, a taxpayer is generally permitted to select his own method of accounting (sec. 446(a)) unless the method selected "does not clearly reflect income" (sec. 446(b)). If it does not, the law permits the IRS to compute the taxpayer's income in a way that will clearly reflect his income.

Thus, the question here is whether failure to capitalize the expenses of producing the film (and thus, of the partnership's rights under the contract) results in a material distortion of income. There is a strong argument under present law that a material distortion of income does occur under these circumstances. See *Commission* v. *Idaho Power Co.*, 418 U.S. 1 (1974), holding that "accepted accounting practice" and "established tax principles" require the capitalization of the cost of acquiring a capital asset, including costs, such as depreciation on equipment, which would generally be deductible if they were not allocable to the construction of the asset. (The production company's contract rights are not a capital asset, but these rights are an asset with a long useful life, so there is a strong argument that the capitalization principle should apply.)

On the other hand, there is one case relied on heavily by the industry which held that a building contractor's income was not distorted where the company constructed apartments and shopping centers under long-term construction contracts and deducted its costs on the cash method, while receiving payments over a five-year period after each project was completed. *C. A. Hunt Engineering Co.*, 15 T.C.M. 1269 (1956). Production company investors have argued that the same result should be allowed in their situation.[14]

A related question is whether the limited partnership is engaged in selling or delivering a product (the film) and is therefore required to maintain an inventory. If this were the case, the labor costs paid in producing the inventory could not be deducted until the inventory item was sold. The argument against that view is that the partnership does not own the film at any time. Thus, it is argued that the production company is selling services (i.e. production services) rather than a product. The Service has ruled that building contractors (operating under circumstances arguably analogous to movie production companies) are selling "services" rather than "property." (See Rev. Rul. 73-438, 1973-2 C.B. 156.)

B. Other issues

In some cases, the personnel hired by the partnership to make the film are not in reality the investors' own employees but are supplied by the distributor. This factor, along with others, raises questions under present law whether a particular service company is really engaged in a joint venture with the distributor (in which case it would have to capitalize its production costs). Issues such as these must be resolved on the facts of the particular situation, such as the nature of the investors' rights to compensation, the distributor's day-to-day involvement in production, etc.

Operation of Shelters

Both of the two types of basic formats which are commonly employed in connection with movie films, the film purchase shelter and the production company shelter, have the same basic elements, i.e., the use of deferral and the use of leverage. In the case of the film purchase shelter, the deferral occurs because of the very rapid depreciation which is allowed in connection with movie films, and which is passed through to the limited partners, particularly in cases where the film is not economically successful. In the case of the production company, the mismatching of expenses and income occurs because the partnership deducts the full cost of producing the film before the film is released and because the contract which the limited partnership enters with the "owner" of the film often provides that payments to the production company for its "services" will be spread over a relatively long time period.

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[14] In 1973, the Internal Revenue Service issued a few private rulings that a movie production partnership may use the cash method of accounting in deducting movie production costs as they are paid. Since 1973, however, the Service has refused to rule favorably in this area and has set up a study group to look further into the merits of the issue.

Both types of arrangements involve the use of leverage (i.e., nonrecourse loans) which allow the limited partners to receive Federal tax deductions for amounts in excess of their economic investment. Some argue that nonrecourse financing distorts the economic substance of the transaction by permitting the taxpayer to deduct money which he has neither lost nor placed at risk. In the case of movie shelter, the use of heavy leverage factors of 3 or 4 to 1 is typical.

The "service company," format, in particular, has become increasingly popular. A special report on movie tax shelters in *Business Week* magazine entitled "How to Invest in Movies," August 25, 1975, states that over half the films produced in the U.S. today are financed through leveraged service partnerships. Some of the recent films produced in this way are "Funny Lady," "Shampoo," "Day of the Locust," "Bite the Bullet," "The Harrad Experiment," and "The Great Gatsby." The result of deducting the entire cost of the film, usually in one year, and of high leveraging, this article states, "is a 400%-of-investment write-off—a tax shelter that ranks with the best that real estate, oil, or cattle ever offered."

7. EQUIPMENT LEASING

General

A business may acquire productive equipment in a variety of ways, including an outright purchase or a lease of the equipment. The use of leasing as a means of acquiring productive equipment has grown substantially in the past fifteen years. Some of the more common types of property and equipment which are presently leased include aircraft, computers, railroad rolling stock, ships and vessels, cable television systems, and oil drilling rigs. Also, utility companies have begun to lease nuclear fuel assemblies.

There are two basic types of equipment leases. The first is the so-called "net" lease. Under the net lease, the equipment is leased for a rental term approximating the useful life of the property, with the lessee assuming financial responsibilities which are normally those of the lessor (such as paying property taxes and insuring the property). Rent payments under a net lease also are ordinarily at a level which enables the lessor to service debt incurred to purchase the property, pay any other expenses, and provide a minimal positive cash flow. As a result, the lessor has very little risk under the net lease.

The other basic type of lease is the "operating" lease, under which the lessor assumes a significantly greater degree of risk than under the net lease. The operating lease is generally for a term less than the useful life of the property, and the lessor is responsible for paying such expenses as insurance and property taxes. Since this type of lease is for a relatively short term, and the original rentals by themselves will not pay off the debt incurred to purchase the property, the lessor in an operating lease takes the risk that rentals from subsequent leases of the property will be insufficient to service the financing costs and cover other cash flow expenses. There are significant differences between the tax treatment accorded net leases and operating leases. For example, individuals who lease equipment under an operating lease may be allowed the investment credit, while the credit would not be available under a net lease.

The equipment leasing shelter is a "deferral" type of shelter. Tax shelter benefits arise largely from postponing income taxes on income from other sources through losses generated by accelerated deductions during the early years of the equipment lease. The principal accelerated deductions are for depreciation under one of the accelerated methods, rapid (60-month) amortization, and prepaid interest. In addition, the use of leverage, through nonrecourse loans, is an integral part of the equipment leasing shelter. The lessor also may be eligible to claim the investment credit, however, the availability of the investment credit was substantially curtailed by the Revenue Act of 1971.

Description of the Shelter

As is the case in many other types of tax shelters, the limited partnership is commonly used in the equipment lease transaction where sheltering of investors' income from other sources is a primary goal. In the typical equipment leasing shelter, a limited partnership is formed with the equity capital provided by a number of individual investors who become limited partners. The promoter, often a corporation, is the general partner. Virtually all of the equity capital is provided by the investors (generally in amounts of not less than $5,000 each), with the general partner contributing little or no equity.

Prior to soliciting limited partnership interests, the promoter has often located a company which is interested in leasing computers, railroad rolling stock or some other type of business machinery or equipment, and has contacted a bank, insurance company or other lender to arrange for financing the equipment purchase. After the limited partnership interests have been sold and the equity capital received, a large portion of the equity capital usually is used to make a 20–25 percent down payment to purchase the equipment. The remaining part of the purchase price generally is financed on a nonrecourse basis, so that the lender's security for his loan is limited to a security interest in the equipment with neither the partnership nor any of the partners having personal liability for the debt. (As a practical matter, the lender's primary security is the credit rating of the lessee and the lessee's ability to make the rental payments over the period.

The partnership generally leases the equipment to the lessee at a rental rate which, over the initial term of the lease, will enable the partnership to repay the loan, plus interest, fees and other expenses, and generate a modest positive cash flow.

In most leasing shelters, the limited partnership elects the method of depreciation or amortization which will generate the largest capital recovery deductions allowable in the early years of the lease. The partnership may, in addition, prepay some of its interest charges, and often, during the first year of operation, pays the promoter for management and syndication fees. The large depreciation, fees, interest, and other expenses generally exceed the partnership's receipts from rental of the equipment during the first 3–7 years of the lease (depending upon the estimated useful life of the leased equipment), and this generates sizable losses for the partnership.

Partnership losses are allocated to the investor-limited partners under the partnership agreement and are used by the individual investors to offset income from other sources (and thus defer taxes on this income for a number of years.) The individual investor may also obtain an apportioned share of the investment credit if the equipment is eligible for the credit and the lease is of a type which enables an individual investor to claim the credit.

Types of Shelter Deductions

Depreciation

A. Accelerated depreciation

The owner of tangible personal property used for the production of income is entitled to a deduction for depreciation. (Where a partnership owns the property, the depreciation deduction is passed through to the individual partners, generally in accordance with the partnership agreement.)

All tangible personal property may be depreciated on a straight-line basis, which provides that an equal portion of the property's basis (less salvage value) is deducted each year of the property's life. Tangible personal property used for the production of income (such as airplanes, computers and cargo containers) is eligible for "accelerated" methods of tax depreciation which allow large deductions initially, with gradually reduced deductions for each successive year of the asset's useful life. The accelerated depreciation methods allowed for equipment include the double-declining balance method [1] and the sum-of-the-years-digits method.[2]

A comparison of these accelerated depreciation methods with straight-line depreciation is illustrated by the following example involving an asset which cost $1 million and has a 10-year useful life. It is also assumed that salvage value is less than ten percent and therefore can be ignored. (sec. 167(f).)

Under either of the accelerated methods shown above, the total depreciation deductions in the earlier years of an asset's life substantially exceed total depreciation allowable under the straight-line method. This is not the case, however, in later years. In the above example, the depreciation to be claimed under the double declining balance method is less than under the straight-line method after the fourth year. Straight line depreciation exceeds sum-of-the-years-digits depreciation after the fifth year.

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[1] The double declining balance method of depreciation, also known as the 200 percent declining balance method, allows a depreciation rate equal to twice the straight-line rate. The declining balance rate is applied to the unrecovered cost, i.e., cost less accumulated depreciation for prior taxable years. Since the depreciation base is reduced to reflect prior depreciation, the amount claimed as depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

[2] The sum-of-the-years-digits method of depreciation is computed using a fraction, the numerator of which is the years' digits in inverse order and the denominator of which is the sum of the number of years. For example, if an asset has an estimated useful life of 10 years, the denominator is the sum of one plus 2 plus 3, etc., plus 10, or 55. The numerator would be 10 in the first year, 9 in the second year, etc. Thus, in the first year, the fraction would be 10/55, in the second year 9/55, etc. As in the case of the declining balance method, the annual depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

Depreciation deductions allowable

[In dollars]

Depreciation method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Straight-line	100, 000	100, 000	100, 000	100, 000	100, 000	100, 000	100, 000	100, 000	100, 000	100, 000	1, 000, 000
Accelerated:											
Double declining balance	200, 000	160, 000	128, 000	102, 400	81, 920	65, 536	65, 536 [1]	65, 536	65, 536	65, 536	1, 000, 000
Sum-of-the-years-digits	181, 818	163, 636	145, 455	127, 273	109, 091	90, 909	72, 727	54, 545	36, 364	18, 182	1, 000, 000

[1] At this stage the taxpayer elects to claim straight-line depreciation for the remaining useful life of the property.

B. Additional first-year depreciation

An owner of equipment is also eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of property (Sec. 179). The amount on which this "bonus" depreciation is calculated is limited to $10,000 ($20,000 for an individual who files a joint return). Bonus depreciation is also available only for property that has a useful life of six years or more. The maximum bonus depreciation is then limited to $2,000 ($4,000 for an individual filing a joint return).

Where the lessor is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitations described above are applied to the individual partners rather than the partnership entity. For example, each one of 40 individual investors who contributed $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft on a leveraged basis, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation alone would provide total deductions of $160,000 to the partners.

The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim, and the partners to deduct, accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

C. Asset Depreciation Range (ADR)

The ADR system for depreciation was authorized by the Congress in the Revenue Act of 1971 in order to help bolster a lagging economy and to eliminate a number of difficult interpretative problems pertaining to depreciation which had arisen under prior law. The ADR system operates under regulations issued by the Treasury Department, and became effective in 1971. (Reg. § 1.167(a)–11.)

Under ADR, depreciation for tangible personal property (including leased property) may be calculated using a shorter than otherwise allowed useful life. The depreciation lives allowed under ADR may be 20 percent shorter than the lives established by the Internal Revenue Service as reasonable useful lives for depreciation of productive assets. (Rev. Proc. 62–21, 1962–2 C.B. 418.) This means, for example, that an asset with a useful life of 10 years may instead be depreciated over a period of 8 years under ADR, giving the taxpayer a type of "accelerated" depreciation deduction (even with straight-line depreciation).[3]

D. Rapid amortization

Certain categories of assets which are subject to equipment leasing transactions are eligible for rapid amortization. Under the rapid amortization provisions, the costs for qualifying categories of property may be amortized over a period of 60 months in lieu of depreciation

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[3] In computing depreciation under the ADR system, a taxpayer also is entitled to use one of two first-year "conventions," or methods, on all assets first placed in service during any one tax year or period. Under the first of these conventions, the taxpayer may elect to claim a half-year's depreciation on all assets put into service at any time during the year. The other convention allows a full year's depreciation for all assets placed in service during the first half of the tax year and no depreciation (for the first year) on assets placed in service during the last half of the tax year.

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deductions otherwise allowable for these assets. Rapid amortization is allowed for pollution control facilities. (sec. 169), railroad rolling stock (sec. 184), and coal mine safety equipment (sec. 187). These provisions terminated at the end of 1975, however there is consideration for continuing these provisions.

E. Depreciation recapture

The equipment leasing shelter does not give rise to the "conversion" characteristic of many other types of shelters because of the full recapture rules that apply to tangible personal property. (Sec. 1245.) When tangible personal property is disposed of at a gain, the gain is "recaptured" as ordinary income to the extent of all previous depreciation deductions claimed on the property (not just accelerated deductions). The recapture treatment for tangible personal property differs from that accorded depreciable real property, which is generally limited to a recapture of the amount by which accelerated depreciation deductions claimed exceeded those allowable on a straight-line basis.

In the case of a partnership, the individual partners are generally allocated a share of the partnership's depreciation recapture in accordance with the provisions of the partnership agreement concerning the allocation of partnership gains. The recognition of depreciation recapture by a partner may be triggered directly by a sale of the depreciated partnership property or indirectly by a disposition of the partner's interest in the partnership itself. Also, if a lender forecloses on the debt used to finance the partnership's purchase of the equipment, this is treated as a disposition which will trigger recapture. The amount "received" in a foreclosure will include the unpaid nonrecourse debt. If this amount exceeds undepreciated basis in the equipment, there will be so-called "phantom gain" which is taxed as ordinary income to the partners.

Investment Credit

As items of tangible personal property used in a productive capacity, the properties used in equipment leasing transactions are generally eligible for the investment credit, which, under the Tax Reduction Act of 1975, was increased to 10 percent through 1976.

An individual lessor (or individual investing in a limited partnership leasing transaction) may claim the investment credit only in two limited alternative situations.[4] (Sec. 46(d)(3).). In the first situation, a noncorporate lessor is allowed the investment credit if the property subject to the lease was produced or manufactured by the lessor. In the second situation, a noncorporate lessor will be allowed the investment credit where the term of the lease (including any renewal options) is less than 50 percent of the depreciable life of the property, and, for the first 12-month period after the property is rented to the lessee, the sum of the lessor's ordinary and necessary business deductions (under section 162) exceeds 15 percent of the lessor's rental income from the property. This is intended to allow the investment credit to an individual (or a limited partner) only where the investors are willing to accept the risks of a short-term "operating" type of

[4] The maximum credit which may be claimed for any one year by a married taxpayer filing a joint return is limited to $25,000 plus 50 percent of the tax liability over $25,000. This limitation is applied separately to each partner in a partnership.

equipment lease. Thus, the investment credit is not available in the typical net lease situation.

Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. (The partner's adjusted basis is reduced by the amount of any deductible partnership losses.) Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership. If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations, where the partnership incurs a debt and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership and their bases are increases accordingly. (Regs. § 1.752–1(e).)

IRS Rulings Policy

Treatment of the lease as a conditional sale

In equipment leasing transactions the partnership's claim that the transaction is a lease may be challenged by the Internal Revenue Service and treated instead as a sale of the equipment by the partnership. The treatment of such leases as sales will result in a total elimination of sheltering characteristics, including disallowances of the lessor's depreciation.

The Service has long been aware of the problem of determining whether a transaction is a lease or is in reality a sale with long-term financing. For a number of years, the Service has had a series of guidelines to determine the income tax treatment of purported leases of equipment. (See Rev. Rul. 55–540, 1955–2 C.B. 39.) Early in 1975, the Service set out criteria under which it will rule on whether a transaction is a lease. Under these criteria it will not rule that a leveraged lease of equipment constitutes a lease unless:

(1) The lessor's equipment purchase is leveraged to an extent less than 80 percent of cost.

(2) At the end of the lease term (including all renewal periods except option periods at a fair market rental rate), the leased property has a residual value of at least 20 percent of its original cost, and a remaining useful life of either one year or 20 percent of the property's original useful life, whichever is longer.

(3) Any option to purchase by the lessee is based on the fair market value of the property at the end of the lease term.

(4) Neither the lessee nor any person related to the lessee (under section 318(a)) furnishes part of the lessor's cost of the property or guarantees any of the lessor's purchase indebtedness.

(5) The lessor demonstrates that it expects to receive an economic profit from the lease, apart from that generated by tax benefits.

(6) The level of rental payments also satisfies certain other criteria.

If the lease does not meet these tests, the Service will not give an advance ruling on the lease transaction. Of course, the taxpayer is free to test the validity of the transaction in court if challenged on audit by the Service.

Operation of Shelter

Equipment leasing transactions are in some cases the only feasible way that some businesses are able to acquire modern equipment. However, it is equally true that equipment leasing attracts investors in high tax brackets for whom the tax deductions and credits are more valuable in terms of their income after taxes than would be their earnings on a direct equity investment. For the lessor, the accelerated depreciation and relatively short useful lives of the assets represent significant tax deferral. Moreover, these deferral benefits are magnified appreciably by the use of leverage. Because of the recapture rules presently applicable in the case of equipment leasing, there is no conversion of ordinary income into capital gains.

The reasons why the business firms which lease the equipment use this form of financing, rather than purchases or other traditional methods of acquiring equipment, vary considerably among industries. One significant factor that frequently influences the decision is the inability of the company to take full advantage of the investment credit and/or rapid depreciation deductions because of low profits or losses. Equipment leasing may also be desirable because the firms might otherwise be unable to finance the acquisition of new equipment. However, equipment leasing may, in the case of the lessee firms and industries, deter structural adjustments necessary to restore the rate of return or investment to a competitive level. In addition, the use of special tax deductions in these cases tends to divert investments to firms where investments may not be economic and in this way distorts the allocation of investment funds among all industries. This means that investable funds do not go to the most productive investment opportunities.

In addition, business firms which finance the acquisition of equipment in this fashion increase their contractual payments, which has much the same effect on them as an increase in their debt.

The equipment leasing industry is highly leveraged and vulnerable to interruptions in the flow of payments. If the lessee is encountering unexpected losses and defaults on his payments, the sequence of defaults through the linkage of financial arrangements limits loanable reserves of lending institutions more than would be the case with more traditional routes for financing equipment acquisitions.

Because of the present tax situation, when an investment is solicited in an equipment leasing venture, it has become common practice to promise a prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources.

8. PROFESSIONAL SPORTS FRANCHISES

General

The professional sports industry provides entertainment in the form of competitive sporting events, such as baseball, basketball, football, hockey, etc. The industry is organized into various joint associations or leagues consisting of individual teams or franchise members. The league members are subject to various league rules which generally have the effect of restraining economic competition. For example, consent of most of the members teams is normally required to grant a new franchise or approve the move of an existing member team from one city to another.

The assets of a professional sports team may generally be divided into three categories: (1) sports and office equipment; (2) contract rights for services of players and other personnel for a specific period ("player contracts"); and (3) franchise rights granted under the league or association agreement. In certain acquisitions, goodwill may also be involved. The professional sports franchise is a contractual right for an indefinite term which entitles a team to various rights, such as the exclusive territorial right to provide sporting events in a given geographical area, the right to participate in and obtain players through the college draft, the right to participate in receipts from radio and television contracts, and the benefit of league rules and regulations restricting business competition among the member clubs.

Although the operation of many sports teams has not resulted in taxable profits in recent years, the cost of acquiring a sports franchise has increased significantly. In addition, the upward trend in acquisition cost does not appear to have been dampened by those cases where actual economic losses have been sustained.[1] Some feel that this is due in large part, to the various tax provisions that allow owners to use losses from sports franchises to shelter income from other sources. These tax provisions provide tax deferral and other tax benefits that can result in profitability from an investment which reflects losses for tax or financial accounting purposes. The major tax benefits in the sports industry are: 1) the deferral of tax payments for one or more years and 2) the conversion of income (and the tax rate) from ordinary income to capital gain.

Tax deferral usually results from the current or rapid deduction of costs from which benefits are derived in later years, i.e., the rapid

[1] According to an article in *U.S. News and World Report*, at least 10 out of 24 major baseball teams, 25 out of 28 major basketball teams, and 11 out of 14 major hockey teams incurred a taxable loss in 1970. However, all of the 26 major football teams either broke even or made an economic profit. "Pro Sports: A Business Boom in Trouble," *U.S. News and World Report*, Vol. 71 (July 5, 1971), p. 56.

writeoff does not accurately represent the actual cost of the exhaustion of an asset. Tax deferral is enhanced if the portion of an aggregate purchase price allocable to depreciable assets having a short useful life is maximized. The principal cost that can be deducted rapidly, or before the related income is recognized in the sports industry, is the cost of a player's contract. Conversion occurs where capital and development costs have been deducted as depreciation or as a salary expense against ordinary income and then, in a later year, the sports franchise is sold at a capital gain.

The entities most commonly used to maximize tax benefits for an individual investor in the sports industry are partnerships and subchapter S corporations. These two forms of ownership are used since they are conduits which permit an individual to use the losses generated by the franchise to offset other income such as salary or dividends. However, not all sports franchises are organized as partnerships or subchapter S corporations.

Types of Shelter Deductions

Depreciation and Amortization

Under present law, the cost of tangible property used in a taxpayer's trade or business may be depreciated and deducted over the useful life of the property. In general, the use of accelerated methods for computing depreciation are permitted if the asset has a useful life of 3 years or more.

In addition, the cost of certain intangible property used in a taxpayer's trade or business can be amortized and deducted over the useful life of the property if certain conditions are met.[2] Te be deductible, the property must have a useful life which is limited in duration and which can be estimated with reasonable accuracy. No deduction is allowed if the useful life of the property is not ascertainable. Unlike tangible property, the use of accelerated methods of depreciation is not permitted for intangible property.

Gains from the sale of both tangible or intangible property are subject to recapture of depreciation as discussed below.

A. Player contracts

Players' contracts are intangible assets and usually represent one of the significant costs of acquiring a sport franchise. While the players' contracts vary with the type of sport involved, the typical contract will provide employment for one year and give the employer (the

[2] A deduction for the exhaustion of usefulness of an intangible asset used in a trade or business is treated as a depreciation deduction although for financial accounting purposes the deduction may be described as an amortization expense and distinguished from depreciation attributable to tangible property.

team) a unilateral option to renew the contract for an additional year at a specified percentage of the player's previous year's salary.[3]

Prior to 1967, the cost of an individual player's contract was deducted as an ordinary and necessary business expense for the taxable year in which paid or incurred depending on the owner's method of accounting. This treatment was based on the theory that individual player's contracts had a useful life of one year or less.[4] However, the bulk purchase of players' contracts was treated by the IRS as an acquisition of one indivisible asset which was to be amortized and depreciated over the useful life of the players. (Rev. Rul. 54–441, 1954–2 C.B. 101.)

In 1967, the IRS reversed its position with respect to individual baseball contracts and ruled that the cost of a player's contract must be capitalized and depreciated over the player's useful life. (Rev. Rul. 67–379, 1967–2 C.B. 127.) In adopting this position, the IRS noted that by reason of the reserve clause, a player contract has a useful life extending beyond the taxable year in which the contract was aquired. In Rev. Rul. 71–137, 1971–1 C.B. 104, the same result was reached with respect to football contracts by virtue of the option clause under the contract.[5] Although the useful life varies from sport to sport, sports teams typically adopt a maximum life of between three and six years. The cost to be capitalized includes amounts paid or incurred upon purchase of a player contract and bonuses paid to players for signing contracts.

Since franchise rights are not usually depreciable because these rights exist for an unlimited period of time, a purchaser of a sports team will benefit from larger depreciation deductions if he is able to allocate more of the aggregate purchase price to player contracts and less to franchise rights. Under present law, there are no specific statutory rules relating to the manner in which allocation must be made. However, the allocation of an aggregate purchase price among the various assets must reflect the relative value of each asset to the value of the whole.[5]

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[3] Baseball and hockey contracts contain a specific "reserve clause" in which the right to renew the contract is itself renewed. Although the team obligates itself for only one year, the effect of this reserve clause in the contract, and certain league rules, is to bind the player to play only for the team which owns the contract. Under league rules, if the player refuses to sign a new contract or play for an additional year under the terms contained in the original contract, the team can prevent the player from playing for another team. Basketball and football player contracts purport to be less restrictive in that, although they provide an option for an additional year's contract, they do not contain a reserve clause *per se*. Neither the contract nor the league rules prevent the player from "playing out his option" and becoming a "free agent." However, in the case of football, if a player becoming a free agent signs a contract with a different team in the NFL, then unless mutually satisfactory arrangements have been reached between the two league teams, the Commissioner of the NFL can assert the right to award to the former team one or more players (including future draft choices) of the acquiring team. This right is currently being litigated.

[4] *Commissioner* v. *Pittsburgh Athletic Co.*, 72 F. 2d 883 (3d Cir. 1934); *Commissioner* v. *Chicago National League Ball Club*, 74 F. 2d 1010 (7th Cir. 1935); and *Helvering* v. *Kansas City American Assn. Baseball Co.*, 75 F. 2d 600 (8th Cir. 1935).

[5] Depending upon the outcome of the litigation involving the reserve clause, the IRS position may be less tenable.

The depreciable basis of player contracts also affects the current capitalization and depreciation of bonus payments to be made in the future under the terms of the contract. Generally, an accrual basis taxpayer is entitled to deduct an unpaid expense for the taxable year in which all the events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461–1(a)(2)). Under this general rule, accrued salaries would ordinarily be deductible expenses for the taxable year in which earned by the employees even if paid in the following taxable year. However, any expenditure which results in the acquisition of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible for the taxable year in which the liability for the expenditure was incurred. This limitation would generally apply to amounts required to be capitalized with respect to a liability for future payments under a player contract.

In addition, another specific limitation would also apply in the case of such a contract if it is treated as a nonqualified deferred compensation plan.

An employer is not entitled to deduct contributions made to or under a nonqualified deferred compensation plan until the taxable year in which an amount attributable to the contribution is includible in the gross income of the employee (sec. 404(a)(5)). The employee-beneficiary of a nonexempt trust must generally include amounts paid on his behalf in his taxable year in which there is no substantial risk of forfeiture (secs. 83, 402(b), and 403(c)). In addition, the Internal Revenue Service has ruled that if compensation is paid by an employer directly to a former employee, under an unfunded plan, such amounts are deductible when *actually* paid in cash or other property (Rev. Rul. 60–31, 1960–1 C.B. 174). Thus, it would seem that deduction under an unfunded plan before payment would be precluded where the useful life of the player contract is shorter than the actual payout period.[6]

B. Franchises

A professional sports franchise is an intangible asset. Under present law, however, depreciation or amortization deductions are not allowed since the useful life of the franchise is not of limited duration and cannot be ascertained. The cost or basis of the franchise would be taken into account in determining gain or loss upon sale or other disposition of the franchise.

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[5] *Harlow* v. *Davock*, 20 T.C. 1075 (1953). Treasury Regulation section 1.167 (a)–5, relating to apportionment of basis, provides that in the case of a lump sum purchase of property the basis for depreciable property cannot exceed an amount which bears the same proportion to the lump sum as the value of depreciable property at the time of acquisition bears to the value of the entire property at that time.

[6] However, one author has suggested that "whether player 'signing' bonuses are correctly treated as an anomaly among the forms of deferred compensation is not clear." (Klinger, "Professional Sports Teams: Tax factors in buying, owning and selling them" 39 J. Tax 276 (Nov. 1973).) On the basis of the Service's ruling that "signing" bonuses are treated as costs of acquiring player contracts (Rev. Rul. 71–137, 1971–1 C.B. 104) and since the contracts are amortizable intangible assets, that author suggests that deduction before payment "seems to be permissible" where the useful life of the contract is shorter than the payment period. Thus, the author suggests that deductions could be generated without cash expenditures.

C. Sports and Office Equipment

Sports and office equipment are tangible personal property which can be depreciated over their respective useful lives. Unlike player contracts and franchise rights, these assets may qualify for the investment credit and additional first year depreciation.

In the typical case, the cost for equipment represents an insignificant portion of the total cost of a sports franchise.

Capital Gain Treatment

A. Sales of franchises

In general, in the case of the sale or exchange of a franchise, any recognized gain or loss is treated as capital gain or loss, if the franchise has been held by the taxpayer for more than 6 months (Rev. Rul. 71–123, 1971–1 C.B. 227). Since the franchise is not a depreciable asset, it is not treated as a section 1231 asset (as described below). In addition, an exchange of one franchise for another would be treated as a like-kind exchange under which the recognition of gain is postponed except to the extent "boot" (i.e., money) is received.

Under a special provision (sec. 1253), the sale or exchange of a franchise will not be treated as the sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise. However, a specific exemption is provided for the transfer of a franchise to engage in a professional sport.

B. Player Contracts

Under present law, depreciable property that is used in a trade or business is not treated as a capital asset. However, under section 1231, a taxpayer who sells depreciable property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. If the losses exceeded the gains, the loss is treated as an ordinary loss. Thus, gains from the sale of player contracts and sports equipment will be treated as capital gain and subject to the more favorable capital gain rates if the contracts were held for more than 6 months.

Recapture of Depreciation

Before 1962, net gains from the sale of personal property used in a trade or business (with certain exceptions) were taxed as capital gain, and losses were generally treated as ordinary losses. In 1962, section 1245 modified this treatment as to most personal property to "recapture" gain on the sale as ordinary income to the extent of all depreciation taken on that property after December 31, 1962. Accordingly, the Internal Revenue Service has ruled that gains from the disposition of depreciable professional baseball and football player contracts which are owned by teams for more than 6 months are subject to recapture as ordinary income.[7] Further, in the case of an early disposition of sports equipment, there will also be recapture of the investment credit.

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[7] Rev. Rul. 67–380, 1967–2 C.B. 291; Rev. Rul. 71–137, 1971–1 C.B. 104.

Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner is personally liable for part of the partnership debt, this also increases his basis. However, under the regulations, where the partnership incurs a debt and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners, including limited partners, are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)).

With respect to a subchapter S corporation, losses that may be passed on to a shareholder are limited to the amount of his investment in the stock and any loans he has made to the corporation. There is thus no resulting tax benefit to the shareholder of a subchapter S corporation if the corporation uses nonrecourse financing.

Form of Ownership

The forms of ownership most commonly used to maximize tax benefits in the sports industry are the partnership and the subchapter S corporation. In general, a partnership is not considered a separate entity for tax purposes; rather, the individual partners are taxed currently on their share of the partnership gains and may deduct partnership losses to the extent of their partnership basis. Similarly, the tax incidents of a subchapter S corporation's operations are generally passed through to its individual shareholders. Both the limited partner and the shareholder may deduct losses of the partnership of cubchapter S corporation to the extent of the adjusted basis in the partner's interest or the shareholder's stock.

While the adjusted basis of the shareholder's stock in a subchapter S corporation does not include any portion of the corporation's liabilities (other than loans than an individual shareholder makes to the corporation), it is possible to increase the adjusted basis of the shareholder's stock by making annual loans to the corporation. These forms of ownership allow an individual investor to use the loss generated by the sports team to offset or "shelter" other income of the investor, such as salary or dividends.

Example of Sports Shelter

In 1976, Mr. Sport and his 3 partners acquire a professional sports franchise for $10 million ($2 million in cash and $8 million in long-term notes bearing interest at 10 percent principal payments beginning in 1980). The assets of the franchise include the franchise rights, players' contracts, sports and office equipment, and a stadium lease, the unexpired term of which is 10 years. The partnership allocates 15 percent of the purchase price to the franchise, 80 percent to the players' contracts, 3 percent to equipment and 2 percent to the stadium lease. A useful life of 5 years is adopted with respect to the players' contracts and a useful life of 10 years is adopted with respect to the equipment. The equipment is depreciated using the straight-line method. Mr. Sport has other personal income of $500,000 in 1976 and has a one-fourth share in the profits and losses of the partnership.

For the taxable year 1976, the partnership has the following income and expenses:

Income:	
Gate receipts	$2,900,000
Television and radio income	1,400,000
Parking and concessions	345,000
Other income	80,000
Total income	4,725,000
Expenses:	
Player salaries	1,700,000
Coaches, scouts, and staff	350,000
Front office administration and overhead	1,050,000
Training	175,000
Interest	800,000
Lease rental	100,000
Total expenses	4,175,000
Net income before depreciation (cash flow)	550,000
Depreciation:	
Player contracts	1,600,000
Equipment	30,000
Lease acquisition cost	20,000
Total depreciation	1,650,000
Net loss for year	1,100,000

Based upon the foregoing assumptions, one-fourth of the net loss from the partnership would have the following effect upon Mr. Sport's tax liability [1] and cash position.

	Without team	With team	Cash benefits
Other taxable income	$500,000	$500,000	
Net loss for team		(275,000)	
Taxable income	500,000	225,000	
Income tax liability	321,000	128,500	
Tax savings			192,500
Cash flow from team			137,500
Total tax savings and cash flow			[2] 330,000

[1] For purposes of this example, the maximum tax on earned income was not used (i.e., none of the $500,000 was earned income).

[2] If another investment opportunity is foregone because of the $500,000 investment in the franchise, the cash benefits attributable to this investment should be adjusted downward to reflect the after-tax income foregone. For example, if Mr. Sport could have invested the $500,000 in taxable securities at a 10 percent yield, the cash benefits attributable to the investment in the franchise would be reduced by $15,000 ($50,000 income less income tax of $35,000).

Operation of Tax Shelter

The principal elements involved in the use of a professional sports franchise as a tax shelter are deferral and capital gains treatment upon the sale or disposition of the franchise or the assets. In many cases, these tax benefits combine to transform an otherwise unprofitable investment into a very profitable one. The tax benefits derived from investing in sports franchises have increased the price of franchises and permitted the operation of some marginal teams which might not be in existence but for the tax savings attributable to deferral and conversion allowed by existing law. Because tax losses may be generated which can be used to offset other income, professional sports franchises have become increasingly attractive tax shelter investments for individuals in high marginal tax brackets.

One practice that increases the tax benefits resulting from the operation of a sports team is the allocation of a large part of the amount paid or incurred for the acquisition of a sports team to depreciable player contracts. Typically, a purchaser of a sports team attempts to allocate as much as possible of the aggregate purchase price of the franchise to player contracts because the cost of a player contract may be depreciated over the useful life of the player. Amounts that are allocated to other assets such as the franchise rights or to goodwill cannot be depreciated since these assets have an indeterminate useful life. The effect of allocating a greater amount of the purchase price to player contracts is to decrease the amount of taxable income or increase the amount of tax losses attributable to the operation of the sports team during the early years.[8]

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[8] Of the total cash consideration paid for an expansion major league football team, the Atlanta Falcons, the purchaser (a subchapter S corporation) treated $7,722,914 as the cost of player contracts and options, $727,086 as deferred interest and the remaining $50,000 as the cost of the franchise. This resulted in tax losses to the corporation of $506,329 in 1967 and $581.047 in 1968 which was passed through to the shareholders on a proportionate basis. Upon audit, the IRS determined that only $1,050,000 should be allocated to the player contracts and options, and $6,722,914 should be allocated to the nondepreciable cost of the National Football League franchise. The taxpayer paid the additional assessment, submitted a claim for refund, and after its disallowance, filed a suit for refund. The court rejected both the taxpayer's initial allocation of $7,722,914 and the Commissioner's allocation of $1,050,000 and concluded that the amount that should have been allocated to the players' contracts and options was $3,035,000. (*Laird v. U.S.*, 391 F. Supp. 656, 75–1 U.S.T.C. 88,565 (D.C. Ga. 1975)). The court further concluded that $4,277,043 represented the value of the television rights granted to the Atlanta Falcons under a 4-year contract between the NFL and the CBS television network and that this amount was not amortizable because the useful life of the television rights was for an indefinite period. This case is presently on appeal in the Fifth Circuit.

Questions have been raised as to the method used by the District Court in allocating the purchase price to the various assets acquired in the *Laird* case. First, the court did not appear to allocate the purchase price according to relative fair market values of the assets acquired. Further, although the court held that the right to participate in receipts from television contracts could not be depreciated since it "had no definite limited useful life the duration of which could be ascertained with reasonable accuracy", the court relied upon the existing 4-year contract in valuing this right for purposes of allocating the purchase price. Concern has been expressed as to whether, if the television contract had only 1 year left at the time of acquisition, the court would have determined the contract's value to be the present value of the right to receive television receipts for only 1 year.

The following table illustrates the allocation made of initial team acquisition costs by professional basketball teams.

Allocation of cost of teams between franchise and player contracts

[In thousands of dollars]

Club	Total cost	Franchise	Player contracts	Players as percent of total
A1	250	250	0	0
A2	985	100	885	89. 8
A3	(1)	(1)	(1)	(1)
A4	295	15	280	94. 9
A5	1, 550	200	1, 350	87. 1
A6	452	172	280	61. 9
A7	20	20	0	0
A8	606	(1)	(1)	(1)
A9	800	425	373	46. 9
A10	255	255	0	0
A11	106	6	100	94. 3
ABA total	4, 713	1, 443	3, 270	69. 4
N1	500	250	250	50. 0
N2	5, 600	1, 100	4, 500	80. 4
N3	5, 175	1, 035	4, 140	80. 0
N4	3, 600	400	3, 200	88. 9
N5	3, 437	400	3, 037	88. 4
N6	1, 250	50	1, 200	96. 0
N7	1, 016	416	600	59. 1
N8	678	200	478	70. 5
N9	3, 635	465	3, 170	87. 2
N10	1, 157	101	1, 056	91. 3
N11	100	100	0	0
N12	1, 907	180	1, 727	90. 6
N13	3, 496	331	3, 166	90. 5
N14	25	25	0	0
N15	3, 040	50	2, 900	98. 4
N16	23	0	23	100
N17	1, 434	150	1, 284	89. 5
NBA total	36, 073	5, 253	30, 821	85. 4

[1] Not available.
Source: Noll and Okner, "The Economics of Professional Basketball (1971).

This allocation may result in a tax loss in many cases even where the operation of the sports team is generating a positive cash flow. Thus, the depreciation claimed by the owner creates tax losses which can be used to shelter other income from taxation.

On the other hand, the seller attempts to allocate most of the aggregate sales price to franchise rights. In this way, a greater amount of any gain is treated as capital gain and a lesser amount is treated as gain attributable to depreciable assets (e.g., players' contracts) subject to recapture as ordinary income.

With respect to recapture upon sale or disposition of a player contract, an argument might be made that the recapture rules for depreciable personal property do not apply in light of the past treatment of salary contracts by the Internal Revenue Service. Prior to its 1967 ruling, the Service treated payments made under a salary contract as ordinary and necessary business expenses when paid. Further, salary expenses which are not capitalized would not be subject to recapture as ordinary income under the judicial tax benefit rule.

Further, the amount of depreciation taken with respect to player contracts will not be recaptured in many cases since a substantial number of the original players may have retired or been "cut" and replaced by a new player. However, in this case, an abandonment loss would be claimed for the adjusted basis of the contract for the player in the year he retired or was cut.

An additional concern relates to the useful life that is adopted with respect to the players' contracts. Typically, sports franchises adopt an average useful life of between three to six years for these contracts. The risk of injury to a player is one of the factors that contributes to this short life and is akin to obsolescence or exhaustion of any other asset. However, it is argued that in many cases, the actual life of the more valuable players extends beyond this period. To the extent that a large part of the total amount capitalized with respect to players' contracts is allocated to players who generally tend to have a longer playing life, the amount allocated is deducted more rapidly than the actual decline in the usefulness of the player.

Industry representatives take the position that sports franchises receive no special tax deductions (such as accelerated depreciation) and that issues respecting the allocation of purchase price among the assets of the franchise are no different than the allocation issues arising in connection with the purchase and sale of any business.

9. PREPAID INTEREST

General

Since many investors in tax shelters acquire partnership interests toward the end of the calendar year, the investors will have not participated in the partnership long enough to generate a large amount of ordinary and necessary expenses in that year. Therefore, deductions for a variety of prepaid expenses have been central to the creation of tax losses.

One of the prepaid expense items widely used by tax shelters generally is prepaid interest. This item normally consists of interest on the financing which the investors incur when they initially purchase the land, apartment building, orchard, cattle, etc.

Normally, the investors (or the limited partnership or other entity which a group of investors has joined) purchase the shelter property toward the end of the calendar year. They finance a large portion of the purchase price either by borrowing funds from a bank, insurance company, or other outlside lender, or by executing a purchase money mortgage note to the person who is selling the property to them. In a purchase money mortgage, the seller himself in effect extends financing to the parties who are buying the property.[1]

Prepaying interest on a debt obligation enables the investors to accelerate the deduction of a sometimes disproportionately large amount of the interest due over the full time period of the loan. This accelerated deduction of a large amount of prepaid interest gives a taxpayer the advantage of tax deferral.

In some cases, the prepayment—which requires a cash outlay—has the effect of reducing the taxpayer's cash flow (net of tax savings). In such circumstances, as long as the deduction lowers the taxpayer's effective tax rate by more than the market rate of interest, the taxpayer will find it to his advantage to shelter his income by prepaying interest. The earlier this deduction can be obtained, the longer the investor has use of the funds and thus can earn additional interest on them.

However, in many tax shelters a deduction for prepaid interest can be generated without adverse cash flow consequences by borrowing more money than is needed and promptly repaying the excess as prepaid interest. Thus, for example, a tax shelter operation needing

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[1] Often, where the investors desire to prepay interest, the seller will accept a lower "purchase price" and a larger amount of interest. Although most sellers would ordinarily desire to receive a larger purchase price (capital gain) and less interest (ordinary income), many sellers are not adversely affected by receiving interest income. For example, some sellers have expiring loss carryovers to absorb the interest income. Other sellers are dealers who would realize short-term capital gain on the sale in any event; still other sellers are pension funds, charities or other tax-exempt organizations.

$900,000 in borrowings for 5 years at 11 percent interest could borrow $1,000,000 at 10 percent interest in December of its first year, and prepay one year's interest immediately. The economic effect of the arrangement is exactly the same as borrowing $900,000 at 11 percent. However, the net effect of structuring the transaction as a borrowing of $1,000,000 with a $100,000 interest prepayment is the acceleration of a $100,000 deduction for 5 years.

The advantage of prepaying interest is much greater for those individuals who receive a large amount of income in a particular year. For such individuals, the prepaid interest deduction can be used to shelter the income in excess of what would ordinarly be received by them. Such a taxpayer will find it to his advantagee to shelter his income by means of a prepaid interest deduction so long as the deduction lowers his effective tax rate by more than the market rate of interest on the amount of cash (net of tax savings) he must put up.

In general, reductions in the effective rate will accrue principally to taxpayers who are in the higher effective tax brackets because the percentage tax reduction in those higher marginal tax brackets makes the manipulation of income and deductions between taxable years a rewarding financial activity. Taxable income and marginal tax rates at the lower end of the progressive tax structure do not yield significant enough financial returns to warrant this type of tax manipulation.

Cash method of accounting.—The cash method of accounting is especially important to investors who want to prepay interest (and other expenses). As is the case with certain other expenses suited to producing accelerated tax losses, under the cash method, interest expense can generally be deducted when it is paid (regardless of the period to which the liability relates). Under the accrual method of accounting, by contrast, interest is deductible as it accrues, regardless of when the interest expense is paid. The accrual method generally achieves a better matching of income and expense than does the cash method.

Present law generally provides that a taxpayer may claim deductions in the year which is proper under the method of accounting which he uses in computing his taxable income (sec. 461). However, the income tax regulations provide that even under the cash method of accounting, an expense which results in creating an asset having a useful life which extends substantially beyond the close of the taxable year may be deducted only in part in the year in which payment is made. Consistent with this rule, the statute provides that if the taxpayer's method of accounting does not clearly reflect income, the Internal Revenue Service may recompute the income using the method which the Service believes does clearly reflect income.

Until the late 1960s tax-oriented investors were able to prepay as much as 5 years' interest with apparent approval by the Service. No specific statutory provision expressly permits prepaid interest to be deducted as paid by a cash method taxpayer. The authority for deducting prepaid interest rests on court cases and on administrative rulings by the Internal Revenue Service. In 1968, however, the Service issued a revenue ruling providing that prepaid interest can be deducted in advance only for a period not in excess of 12 months following the taxable year in which the payment is made, and even then, only if the deduction does not materially distort income.

Administrative Rulings

In Rev. Rul. 68–643, 1968–2 C.B. 76, the Service took the position that a deduction of prepaid interest by a cash basis taxpayer will be disallowed as materially distorting income except in certain limited circumstances. Prepayment for a period extending for more than 12 months beyond the end of the current taxable year will be deemed to create a material distortion of income. In such a case the interest will be allocated over the taxable years involved.

Deductions for interest paid in advance for a period not in excess of 12 months after the last day of the taxable year of payment will be considered on a case-by-case basis to determine whether a material distortion of income has resulted.

The ruling sets forth several factors which (among others) may be considered in determining whether there is a material distortion of income: the amount of the taxpayer's income in the taxable year of payment; his income in previous years; the amount of prepaid interest; the time of payment; the reason for the prepayment; and the presence of a varying rate of interest over the term of the loan.[2] Two recent court decisions have upheld the Service's application of these criteria to particular interest prepayments.[3]

Items related to prepaid interest

Points.—It is important under present law to distinguish between "points," which are viewed as additional interest charges, and service charges such as those which a lender renders in the course of processing a loan application. In some situations, service charges are treated for tax purposes as nondeductible capital expenditures (rather than as deductible interest or as ordinary and necessary business expenses). In general, the determination of whether points or loan processing fees are deductible when paid depends on the facts of the particular situation, and the Service has published several rulings indicating whether particular payments of this kind are deductible in full when paid.

Loan commitment fees.—Often a bank or other commercial lender charges a fee for agreeing to make a loan in the future if and when a borrower desires to borrow the funds. Ordinarily, this fee is not interest since it does not relate to a borrower's use of money. In some cases, however, the payment of the fee has been treated as an ordinary and necessary business expense deduction.

Prepayment penalties.—Generally, penalties for liquidating the principal amount of a mortgage or other loan before its due date are deductible by the payor as interest.

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[2] The Service has not made clear whether these criteria apply, in the case of a partnership, solely at the parnership level or solely to each partner or possibly at both levels.

[3] *G. Douglas Burck* v. *Commissioner*, — F. 2d —, 76–1 U.S.T.C. par. 9283 (2d Cir. 1976), affg. 63 T.C. 556 (1975) (one year's interest on a 27-month loan prepaid on December 29; cash method taxpayer realized an unusually large capital gain during the year; a $377,000 prepayment reduced his taxable income from $419,000 to $41,400; the court allowed only 3/365 of interest in the year of payment); *Andrew A. Sandor*, 62 T.C. 469 (1974) (5 years' prepaid interest intended to shelter unusually high capital gains during year held not deductible at all in the year of payment by a cash method taxpayer).

Loan discount.—In this type of arrangement the bank (or other lender) delivers to the borrower an amount which is smaller than the face amount of the loan. The difference is the charge for the debtor's use of the borrowed funds. Generally, the borrower cannot deduct the amount withheld in the year he receives the loan proceeds; instead, he can deduct the "discount" only over the term of the loan as he pays the face amount of the loan. (Rev. Rul. 75–12, 1975–2 I.R.B. 6.)

Wraparound Mortgage

A recent technique used to justify larger amounts of prepaid interest within the Service's present guidelines than can be obtained under conventional financing is the "wraparound mortgage." A wraparound mortgage works as follows: Typically, the farm, shopping center, or other property which the shelter-minded investors are purchasing is encumbered by an existing first mortgage. The investor executes to the seller a new purchase money obligation whose face amount includes both the unpaid balance of the first mortgage and the new financing supplied by the seller (which would ordinarily take the form of a second mortgage).

The buyers agree to pay (and to prepay) interest on the face amount of the wraparound note, while the seller agrees to continue paying the interest on the first mortgage (out of the interest payments which he receives from the buyers). In some cases the additional prepaid interest which the buyer claims on the wraparound note is negotiated as a substitute for a larger down payment by the buyers, thereby increasing the deductible portion of the initial payments which they make to the seller. Since a wraparound mortgage usually bears a higher rate of interest than the first mortgage, the seller is motivated to use a wraparound mortgage because he is relending the balance of the first mortgage to the investor at a higher rate of interest than he pays his lender. Thus, the amount received as a result of the difference between the interest rates is additional profit to him.

To illustrate how a wraparound mortgage works, assume that the sale price of an existing apartment building which a group of investors desires to buy at the end of 1975 is $1,500,000, and that there is an existing 7 percent first mortgage on the property, the unpaid balance of which is $1 million.

Conventional financing.—Under conventional terms, the buyers might pay $100,000 cash down, take the property subject to the existing first mortgage, and agree to a $400,000 second mortgage at a 9 percent interest rate. The investors would agree to pay interest and principal on the existing first mortgage. However, without the permission of the lender of the first mortgage, the buyer/investors cannot prepay interest in 1975 on the first mortgage. They could, however, agree with the seller to prepay interest on the new financing extended by the seller under the second mortgage. The seller would then receive a total of $136,000 in the year of sale, as follows:

Conventional financing—Purchase price: $1,500,000

Seller	Buyers (syndicate)	
	Pay:	
Existing 1st mortgage (7 percent), unpaid balance $1 million.	Cash down payment	$100,000
	1st mortgage (taken subject to)	1,000,000
	2d mortgage (9 percent)	400,000
	Total	1,500,000
Cash flow:	Total paid by buyers:	
$136,000 received from buyers and retained.	Down payment—1975	100,000
	Prepaid interest (1 year on 2d mortgage—1975	36,000
	Total	136,000
	Interest paid by buyers on 1st mortgage—1976	70,000
	Total	206,000

Under this type of conventional financing, the investors would probably claim prepaid interest deductions for 1975 in the amount of $36,000.

Wraparound technique.—Using the wraparound mortgage technique, the investors might make a down payment of $66,000 and execute to the seller a mortgage for $1.4 million at 7 percent. (The face amount of the new obligation executed by the investors includes, or "wraps around," the existing first mortgage on the property.) The buyers then prepay one year's interest on the face amount of the wraparound mortgage, or $98,000 (7 percent of $1.4 million). They might also pay the seller three points on the wraparound mortgage, or $42,000. The seller would agree to continue to be responsible for making payments on the first mortgage. (In the following year, the seller would therefore pay $70,000 to the lender on the first mortgage, and retain a net of $136,000.)

The wraparound mortgage can be described as follows:

Wraparound mortgage—Purchase price: $1,466,000

Seller		Buyers (syndicate)	
		Pay:	
$1,000,000 mortgage (seller will continue to discharge out of payments he receives from the buyers).		Cash down payment	$66,000
Cash flow:		Purchase money mortgage (wraparound) 7 percent	1,400,000
Received from Buyers—1975	$206,000	Total	1,466,000
Less: Interest due on 1st mortgage 1976	70,000	Three points on new mortgage	42,000
Retained by seller	136,000	Total paid by Buyers—1975:	
		Down payment	66,000
		Prepaid interest—1 year on purchase money mortgage	98,000
		Three points on new mortgage	42,000
		Total	206,000

By using this technique, the seller nets the same $136,000 as under conventional terms, but the wraparound technique enables the investors to claim $140,000 in interest deductions in 1975 (rather than $36,000).[4]

In this example the total purchase price of the property has been reduced from $1.5 million to $1,466,000. The seller nets the same amount ($136,000) under either financing method. However, the buyers/investors have increased their claim to deduct one year's prepaid interest from $36,000 to $98,000. They have also paid points on the face of the wraparound mortgage which gives the seller the same dollar amount ($136,000) which he would have received under conventional financing and also gives the investors an additional interest deduction. The investors have in effect prepaid interest on the first mortgage without obtaining the lender's permission to do so. They have also converted $34,000 of purchase price dollars, if conventional financing had been used) into deductible interest dollars.

Recently, the Service has taken an administrative position indicating that it will measure the permissible prepaid interest deduction (under the tests of Rev. Rul. 68–643) not by reference to the face amount of the wraparound note but only by reference to the new credit which the seller extends to the buyer.[5]

Operation of Shelter

The effect of denying deductions for interest which is prepaid by a cash method taxpayer is to place that taxpayer on the accrual method as to a single item of his income and expense (but not as to other items). However, critics of this treatment of prepaid interest point out that the rationale for denying the deductions goes beyond the concept that cash basis taxpayers cannot deduct payments of expenses whose benefit (use of money, in this case) will be realized beyond the current year. The cash method, it is argued, inherently departs from good accounting principles (matching of income and expenses, etc.), but has been permitted for reasons of convenience and ease of bookkeeping. In this view, a "clear reflection of income" test cannot logically be applied to only one item on a cash basis taxpayer's return since almost always he would report the expense differently if his return were prepared on

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[4] Typically, in lieu of having the investors pay points to the seller, the interest rate on the wraparound is higher than the existing interest rate on the first mortgage. In this example, the interest rate on the $1.400,000 wraparound mortgage would likely to be higher than the presumably lower interest rate on the first mortgage. In such cases, the seller would retain (and profit from) the increased interest amounts on the first mortgage which the investors will pay to him but which he will not have to pay over to the lender on the first mortgage.

[5] In Rev. Rul. 75–99, 1975–12 I.R.B. 14, a party owning real estate encumbered by a $300x first mortgage (7 percent) executed a note to a real estate investment trust in the amount of $400x at 8 percent per year. The trust advanced $100x to the borrower. The trust also agreed to make the periodic principal and interest payments on the first mortgage. The ruling holds that the indebtedness betwen the trust and the borrower giving rise to an obligation to pay interest to the trust is not the face amount of the wraparound note, but only the $100x "actually" loaned by the trust. Payments by the trust on the first mortgage were considered made on behalf of the borrower.

the accrual method on accounting.[6] On the other hand, it is argued that prepaid interest, like prepaid rent and prepaid insurance, is an expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year. If so, even under the cash method of accounting, prepaid interest is properly deductible no earlier than over the period to which it relates. This rationale has been applied to prepaid (or advance) rentals and prepaid insurance[7] even though requiring prepaid rent or prepaid insurance premiums to be deducted no earlier than over the period to which they relate arguably puts a cash method taxpayer on an accrual method for such items.

Critics of the Service's ruling tests for prepaid interest also object to a "case by case" approach to determine deductions. They argue that the deduction by the same taxpayer of prepaid interest should not be allowed in one year and perhaps not in another year. Nor should prepaid interest be deductible by one taxpayer who has a large amount of income in a given year after the deduction (so that the deduction does not "distort" his income) but possibly not be deductible by another taxpayer who has little or no taxable income after taking the deduction.[8]

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[6] Some critics have also contended that a prepayment of interest in order to offset a nonrecurring or "one-shot" increase in income during a year should not be regarded as distorting income because the deduction, in effect, levels out his income.

[7] *Commissioner* v. *Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942) (prepaid insurance) ; *Norman Baker Smith*, 51 T.C. 429 (1968) (prepaid rent) ; *University Properties Inc.*, 45 T.C. 416, 421 (1966), aff'd, 387 F.2d 83 (9th Cir. 1967) (prepaid rent) ; *Martha R. Peters*, 4 T.C. 1236 (prepaid insurance) ; Rev. Rul. 70–413, 1970–2 C.B. 103 (prepaid insurance) ; contra, *Waldheim Realty & Inv. Co.* v. *Commissioner*, 245 F.2d 823 (8th Cir. 1957).

[8] Some commentators who have analyzed the Service's tests and the case law believe that the rule of present law is, in effect, that the Commissioner can place cash method taxpayers on the accrual method as to prepaid interest if a deduction under the cash method causes a great (rather than merely some) disparity between taxable income as computed on the cash method and as computed on the accrual method.

10. PARTNERSHIP PROVISIONS

General

The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership, which, upon meeting certain requirements, is subject to both the general partnership provisions and certain provisions of the income tax regulations having particular application to limited partnerships. A limited partner is a passive investor who is not personally liable for any more than his equity contribution to the partnership (plus his agreed future contributions), even though he may benefit by certain partnership provisions allowing him to deduct losses in excess of that contribution.

Under the partnership provisions of the Internal Revenue Code (secs. 701–771), a partnership is generally treated as an entity for accounting purposes and treated as a conduit for taxpaying purposes. It is an entity for purposes of calculating taxable income and many particular items of income, deduction, and credit (sec. 703). It is also an entity for purposes of reporting information to the Internal Revenue Service (sec. 6031).

A partnership is a conduit for purposes of income tax liability and payment. Each partner takes into income his own "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). The liability for income tax payment is that of the partner, and not of the partnership (sec. 701). Thus, that income is taxed at only one level—the partner's level (as distinguished from the corporation, where income is taxed at the corporate level and dividends are taxed at the shareholder level [1]). This means that the partner is taxed on the partnership profits even though none of these profits may be distributed to the partner.

Partnership losses, deductions, and credits pass through to the partner and can be used to offset other income, thereby reducing the income tax liability of the partner. The amount of losses which a partner may deduct under these provisions for a particular year is not to exceed the amount of the adjusted basis of his partnership interest (sec. 704 (d)), which, at the inception of the partnership, equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities. With respect to limited partnerships, the Treasury Regulations (§ 1.752–1(e)) provide that a limited partner's share of the partnership's liabilities includes a pro

[1] Electing small business corporations (subchapter S corporations) are taxed in a manner roughly similar to partnerships; a number of the relevant elements of this treatment are discussed below.

rata share (the same proportion in which he shares profits) of all liabilities with respect to which there is no personal liability ("nonrecourse liability"). (See Nonrecourse Loans, under IRS Rulings Policy, below, for an explanation of the impact of this provision of the Treasury Regulations.)

Subject to the restriction that its purpose is not to avoid or evade tax, a limited or general partnership agreement may provide for the manner in which the partnership's items of income, gain, loss, deduction, or credit will be allocated among the partners (sec. 704).

Qualification for Partnership Tax Status

The Treasury Regulations (§§ 301.7701–2 and 301.7701–3) provide that, in order to qualify for the partnership tax treatment described above, a limited partnership must be lacking in at least two of the following four characteristics peculiar to corporations: (1) centralization of management, (2) continuity of life, (3) free transferability of interest, and (4) limited liability. If the limited partnership is not lacking in at least two of these corporate characteristics (or, put another way, if at least three of the four corporate characteristics are present), it will be subject to tax treatment as a corporation, one major consequence of which is to preclude the passthrough of the tax shelter losses to the investors. Thus, it is of crucial importance for tax shelter purposes that the limited partnership have fewer than three of the four corporate characteristics so that its partners can deduct its tax shelter losses.

Centralization of Management

In the context of a limited partnership, centralization of management exists if substantially all of the interests in the partnership are owned by the limited partners. While the Internal Revenue Service disavows any mechanical test for advance ruling purposes, the staff understands that if the general partners in the aggregate have a 20-percent or greater interest in the partnership capital obtained through capital contributions, the limited partnership will be treated as lacking the corporate characteristic of centralization of management. In most limited partnerships, the general partner does not have a 20-percent interest in capital, and for planning purposes, this characteristic generally is considered to be present.

Continuity of Life

The regulations provide three distinct situations by which a limited partnership would be lacking in the corporate characteristic of continuity of life:

1. if the bankruptcy, dissolution, retirement, resignation, death, insanity, or expulsion of a general partner causes a dissolution of the partnership (even though the partnership would not be dissolved if the remaining general partners or all remaining partners agree to continue the partnership);
2. if a general partner has the power at any time to dissolve the partnership; or

3. if the partnership is formed pursuant to a State statute corresponding to the Uniform Limited Partnership Act.[2]

Free Transferability of Interest

Most limited partnerships encounter little difficulty in negating the characteristic of free transferability of interest. This characteristic relates exclusively to the ability of a limited partner to make another person a substitute limited partner. Thus, notwithstanding a limited partner's right to assign profits and losses, free transferability can be negated simply by providing that no assignee of a limited partner may become a substitute limited partner without the prior consent of the general partners. In the tax shelter area, general partners normally consent to such substitutions.

Limited Liability

In the context of a limited partnership, the characteristic of limited liability is not present if the general partner has substantial assets (other than the interest in the partnership) which can be reached by a creditor or if the general partner is not a "dummy" acting as an agent of the limited partners.

IRS Rulings Policy

Limited Liability—Net Worth Test

In connection with the characteristic of limited liability, the Service has set forth certain net worth requirements which must be met by a corporation serving as the sole general partner of a limited partnership before the Service will consider issuing an advance ruling classifying the limited partnership as a partnership for Federal tax purposes (Rev. Proc. 72–13, 1972–1 C.B. 735). The Service requires a net worth, based on a current fair market value test, equal to the sum of 10 percent or 15 percent of the capital raised in the partnership, the percentage depending upon the amount of capital raised:

1. if the capital raised is less than $1,666,667, the net worth of the corporate general partner must be at least 15 percent of the capital;
2. if the capital raised is between $1,666,667 and $2,500,000, the net worth of the corporate general partner must be at least $250,000; and
3. if the capital raised exceeds $2,500,000, the net worth of the corporate general partner must be at least 10 percent of the capital.

In calculating net worth, the corporation's interest in the limited partnership and receivables to and from the limited partnership are excluded.

Rules also are provided for cases where the corporate general partner has interests in more than one limited partnership.

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[2] In 1973 and again in 1974, California amended a section of its version of the Uniform Limited Partnership Act to conform with the corresponding section of the Uniform Limited Partnership Act. Seemingly, the sole purpose of these conforming amendments was to facilitate California limited partnerships negating the corporate characteristic of continuity of life. See Rev. Rul. 74–320, 1974–2 C.B. 404, and Announcement 75–23, 1975–11 C.B. 87, ruling that those amendments resulted in the negation of the characteristic of continuity of life.

Common Ownership of Corporate General Partner

In addition to its net worth requirements, the Service has established (Rev. Proc. 72–13, *supra*) certain other restrictions with regard to the percentage of stock ownership that the limited partners may have in a sole corporate general partner. Thus, an advance ruling will not be issued if the limited partners directly or indirectly own more than 20 percent of the stock of the corporate general partner or its affiliates. Moreover, the Service will not issue an advance ruling if the purchase of a limited partnership interest by a limited partner would entail either a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates. Seemingly, the purpose of these restrictions is to prevent a substantial identity of interest in the corporate general partner and the limited partnership.[3]

Principal Purpose of Avoidance of Federal Taxes

In Rev. Proc. 74–17, 1974–1 C.B. 438, the Service set forth its position that it will not issue an advance ruling where factual questions are raised as to whether the principal purpose of the limited partnership's formation is the reduction of Federal taxes. The following operating rules ordinarily must be complied with in order for the Service to be willing to issue an advance ruling that a limited partnership is a partnership under the Internal Revenue Code:

(1) At all times during the existence of the partnership, the general partners, taken together, must have at least a one-percent interest in each material item of partnership income, gain, loss, deduction, or credit.

(2) For the first two years of operation of the limited partnership, the partners may not claim aggregate deductions which exceed the amount of equity capital invested in the limited partnership. This requirement generally precludes the use of nonrecourse liability included in the partners' adjusted bases to absorb losses incurred during the first two years of operation.

(3) Any creditor who has made a nonrecourse loan to the limited partnership must not have or acquire at any time, as a result of that loan, any direct or indirect interest, other than as a secured creditor, in the profits, capital or property of the partnership.

Syndication and Organization Fees

Until recently, it has been the common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. In Rev. Rul. 75–214 (1975–23 I.R.B. 9), the Service ruled that such payments to general partners for services

[3] The most extreme case of this situation would be where the corporation is wholly owned by all the limited partners in proportion to their partnership interests. A persuasive argument could be made here that, in substance, the shareholders of the corporation were conducting corporate business through a limited partnership while having essentially the same rights and obligations had the business been operated directly by the corporation. The Service apparently believes that the danger of substantial identity of interest is too great to be acceptable whenever the limited partners' ownership of stock in the corporate general partner is greater than 20 percent.

rendered in organizing and syndicating a partnership constitute capital expenditures which are not currently deductible.[4]

Nonrecourse Loans

Commonly, the equity contributions of limited partners do not adequately capitalize the operations of a limited partnership. The additional capital frequently is obtained by borrowing, using partnership property as security, without the limited partnership or its partners incurring any personal liability with respect to that borrowing. The loans obtained by the limited partnership provide "leverage" by making it possible for a partner to deduct tax losses in excess of his equity contribution to the partnership.

A limited partner may deduct from his personal income all the deductible items of the partnership which are allocated to him under the partnership agreement, but not more than the amount of his basis for his interest in the partnership, which is reduced by the amount of the deductions as they are taken.

In general, at the inception of the partnership, a limited partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. Under the Treasury's income tax regulations (§ 1.752–1(e)), "where none of the partners have any personal liability with respect to partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits."[5] Through the use of this device, a limited partner may obtain a substantial increase in his basis, and, thus, in the amount of losses he may deduct.

For example, if a limited partner pays $10,000 for a 5 percent interest in the capital and profits and losses of a limited partnership which obtains a nonrecourse loan of $500,000, the limited partner's basis in his interest would be $35,000 ($10,000 plus 5% of $500,000). Thus, as a result of "leveraging", the limited partner may be able to deduct an amount far exceeding that of his actual investment.[6]

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[4] In a recent case involving a related situation, the United States Tax Court disallowed the deductions for certain payments made to a general partner. *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974), on appeal to C.A. 5 (payment for services rendered for conducting a feasibility study of a proposed office-showroom facility, obtaining financing, and developing a building for the partnership).

[5] This rule has been justified as an adaptation to the limited partnership situation of a principle set forth by the United States Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

[6] Where a lender requires that the general partner be personally liable on a loan (such as a construction loan), some limited partnerships have attempted to create basis for each of the limited partners by providing for contingent contributions; i.e., the limited partners are obligated to make certain additional contributions if they are called for by the general partner. The rights to call for the additional contributions commonly would expire upon the obtaining of nonrecourse financing and, in some cases, there may well have been no intention to call for such additional contributions. The intended effect of this arrangement is to provide the same increase in the limited partners' bases for their partnership interests (hence, the same increase in the ceiling for tax shelter deductions) as would have been the case if the general partner had not been made personally liable on the loan.

It should be noted that while the nonrecourse loan rule may permit an investor to take deductions exceeding his initial investment, this rule can also result in the subsequent recognition by the investor of substantial amounts of both ordinary and capital gain income where either the partnership sells or otherwise disposes of the partnership property that secures the nonrecourse loan or a limited partner sells or otherwise disposes of his partnership interest.[7]

Sometimes the gain recognized in these situations is referred to as "phantom gain" due to the fact that the sale or disposition generates little or no cash (such as in a mortgage foreclosure, which is treated as taxable disposition of the property), but does result in a gain with respect to which substantial tax liability is created. In other words, in such a case, the taxpayer is required to repay part or all of his interest-free loan from the Government (the earlier savings from the tax shelter), which to a great extent was generated by nonrecourse borrowings.

In 1972, the Service issued two rulings involving nonrecourse loans. While both rulings dealt with and have particular application to limited partnerships engaged in oil and gas exploration, they are susceptible to a much broader application. In Rev. Rul. 72–135, 1972–1 C.B. 200, the Service ruled that a nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would constitute a contribution to the capital of the partnership by the general partner, and not a loan, thereby precluding an increase in the basis of the limited partner's partnership interest with respect to any portion of such a loan. In Rev. Rul. 72–350, 1972–2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by highly speculative and relatively low value property of the partnership, and which was convertible into a 25 percent interest in the partnership's profits, did not constitute a bona fide debt, but was, in reality, equity capital placed at the risk of the partnership's business. This, too, would preclude increases in the bases of the limited partner's interests.

Partnership Allocations

Special Allocations

Under the partnership provisions, a limited (or a general) partnership agreement may allocate "any item of income, gain, loss, deduction, or credit among the partners in a manner that is disproportionate to the capital contributions of such partners (sec. 704(a), (b)(1)). These are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)).

[7] In general, in computing the gains derived upon these sales or dispositions, the outstanding principal amount of the nonrecourse loan (which usually is at or near its original amount) must be added to the amount received, and will thus increase the amount of gain to be recognized. Because the partnership property or the partner's partnership interest may at that time have a very low basis (because of such previous claimed accelerated deductions as depreciation), the recognizable gain may be sizeable in amount. Under the partnership tax law (sec. 751) there may be a recapture of certain accelerated deductions and, consequently, there may be recognition of ordinary income.

Special allocations of profits, losses, income items, and deductions may be used to combine tax-oriented and nontax-oriented investors in a single partnership. Typically, the tax benefits and large portions of the capital appreciation on resale are given to the high-income investor, while greater security and first return of cashflow are given to the nontax-oriented investor.

A special allocation will not be recognized if its principal purpose is to avoid or evade a Federal tax (sec. 704(b)(2)). In determining whether a special allocation has been made principally for the avoidance of income tax, the regulations focus upon whether the special allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences (Regs. § 1.704–1(b)(2)). The regulations also inquire as to whether there was a business purpose for this special allocation, whether related items from the same source are subject to the same allocation, whether the allocation ignored normal business factors and was made after the amount of the specially allocated item could reasonably be estimated, the duration of the allocation, and the overall tax consequences of the allocation.

A primary case dealing with this issue, *Stanley C. Orrisch*, 55 T.C. 395 (1970), affirmed C.A. 9, disallowed a deduction of 100 percent of the depreciation by one of the partners in a two-man partnership. The allocation in this case was found to have been made for the principal purpose of evading or avoiding income tax, the parties failing to demonstrate any economic effect of the allocation. The court indicated that the taxpayer had not shown that he had borne the risk of economic depreciation of the property in question.

In the case of *Leon A. Harris*, 61 T.C. 770 (1974), the United States Tax Court sustained the special allocation to a partner of a loss sustained upon the sale of an interest in a shopping center, where the entire sales proceeds were distributed to that partner and his capital account was charged with the entire loss on the sale.

More recently, the Service announced (Rev. Proc. 74–22, 1974–2 C.B. 476) that it would not issue advance rulings as to whether the principal purpose of a special allocation is the avoidance or evasion of Federal income tax.

Retroactive Allocations

Investments in tax shelter limited partnerships are commonly made toward the end of the taxable year. It is also common for the limited partnership to have been formed earlier in the year on a skeletal basis with one general partner and a so-called "dummy" limited partner. In many cases the limited partnership incurs substantial deductible expenses prior to the year-end entry of the limited partner-investors.

In these tax shelter limited partnerships, the limited partnership usually allocates a full share of the partnership losses for the entire year to those limited partners joining at the close of the taxable year. These are referred to as "retroactive allocations." For example, in the case of a limited partnership owning an apartment house which has been under construction for a substantial part of the year, where construction interest and certain deductible taxes have been paid during that time, such deductions might be retroactively allocated to investors entering the partnership on, say, December 28th of that year.

There has been much debate about whether a retroactive allocation of loss is permissible under the Internal Revenue Code. Different commentors have interpreted the partnership provisions of the Code to both support and reject retroactive allocations.[8]

Three cases, dealing directly or indirectly with this issue, provide some support for retroactive allocations. *Smith* v. *Commissioner*, 331 F.2d 298 (C.A. 7, 1964) (retroactive allocation allowed for lack of finding of purpose to avoid tax); *Jean V. Kresser*, 54 T.C. 1621 (1970) (retroactive allocation disallowed for failure to modify the partnership agreement, but the court indicated that if the agreement had been so modified, the allocation would have been sustained, notwithstanding its recognition of avoidance of tax as a principal purpose); and *Norman A. Rodman*, 32 T.C.M. 1307 (1973) (retroactive allocation of profits, as argued by the Government, sustained).

Partnership Additional First-Year Depreciation

An owner of tangible personal property is eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of the property (sec. 179). The cost of the property on which this "bonus" depreciation is calculated is not to exceed $10,000 ($20,000 for an individual who files a joint return). The maximum bonus depreciation deduction is thus limited to $2,000 ($4,000 for an individual filing a joint return). Bonus depreciation is available only for property that has a useful life of six years or more.

Where the owner is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitation described above is applied to the individual partners rather than to the partnership entity. For example, each one of 40 individual investors who contributed $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft on a leveraged basis, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would provide total deductions to the partners of $160,000.[9]

A corporation, however, is allowed to deduct only $2,000 in additional first-year depreciation. Thus, in the case of the purchase of an aircraft, as described above, a corporation would be limited to $2,000

[8] Read in conjunction with each other, sections 704(a) and 761(c) would seem to support retroactive allocations. Some would interpret section 704(b)(2), which prohibits an allocation having tax avoidance as its principal purpose, as being inapplicable to allocations of net profit and loss, as opposed to an allocation of a particular item of income or loss. Others arrive at the opposite interpretation of this provision. Yet another partnership provision, section 706(c)(2)(B), is proffered by many as the provision which would restrict a partner's losses to those incurred in that part of the year during which that person was a partner. Here again, there are contrary interpretations by other tax experts.

[9] The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim (and the partners to deduct) accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

in additional first-year depreciation, whereas the partnership would pass through to the partners total first-year additional depreciation of $160,000.

Issues

Questions have been directed to the provision of the income tax regulations (§ 1.752–1(e)), which allows a limited partner to increase the basis in his investment, and therefore the amount of losses that he may deduct, by a portion of nonrecourse indebtedness. Under this regulation, the investors are able to use borrowed funds with respect to which they have no personal liability to generate deductions in amounts larger than what they have at risk in the limited partnership. On the other hand, it has been argued that this provision of the income tax regulations applying to limited partners is no more than an adaption of the principle of a Supreme Court case [10] where nonrecourse indebtedness, regardless of the form of business involved, is added to the owner's basis of the property.

Questions have also been raised as to whether syndication and organization fees paid by tax-sheltered limited partnerships are in the nature of capital expenditures and should not be deducted. This position has been sustained recently in the courts and in an IRS ruling.

One of the more significant issues arising under the partnership tax provisions concerns the allocation by a limited partnership to a new partner of deductions that were incurred or paid prior to the time of his entrance into the partnership. The partnership provisions of the Internal Revenue Code are unclear as to whether these allocations can be made. The consequence of allowing these allocations, essentially, is that new limited partners, who ordinarily invest in the partnership towards the close of the taxable year, deduct expenses which were incurred or paid prior to their entry into the partnership.

Some argue that these retroactive allocations are proper because the funds invested by the new limited partners serve to reimburse the original partners for their expenditures (or other deductible items) and that, as an economic matter, the new partners have incurred the costs for which they are taking deductions. However, this argument may lose its persuasiveness when the new investor in a limited partnership situation is compared to that of an investor who directly purchases property which had previously generated tax losses during the taxable year. It is clear that in the latter case the investor would not be entitled to any deductions for the losses incurred prior to his ownership of the property, notwithstanding the fact that he may, in effect, be reimbursing the seller of the property for losses already incurred.

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[10] *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

11. HOUSE BILL—LIMITATION ON ARTIFICIAL LOSSES (LAL)

The House bill imposes a limitation, commonly referred to as LAL (limitation on artificial losses), on the extent to which losses arising from accelerated deductions with respect to certain activities can be used to offset a taxpayer's other income. Under this limitation, specified accelerated deductions are not allowed in the taxable year in which such deductions are paid or incurred to the extent they exceed a taxpayer's net income from that activity. These deductions are to be deferred until either the taxpayer has income from that activity in a future taxable year or until he disposes of the property to which the accelerated deductions are attributable. In all of these activities, the limitation is not to apply to true economic losses which are to continue to be deducted currently. The following is a brief description of the application of the LAL provision with respect to each of the activities to which it applies.

1. Real estate

In the case of real estate, all real property would be fully consolidated for purposes of LAL. The accelerated deductions attributable to real property would be deferred in a "deferred deduction account" to a later year to the extent that the deductions exceed the taxpayer's net related income from real property. Net related income is gross income from real property less the "ordinary deductions" attributable to real property (deductions other than the accelerated deductions). The limitation would not apply to true economic losses which would continue to be deductible currently.

The accelerated deductions which would be limited as indicated above are the deductions for interest and taxes during the construction period, and accelerated depreciation in excess of straight line depreciation.

In general, LAL would apply to commercial and residential property where the construction begins after December 31, 1975. However, LAL would not apply to residential real property if (*a*) before January 1, 1977, the taxpayer has acquired the site (or has a binding option to acquire the site) and there is a firm commitment for the permanent financing of the property and if (*b*) construction begins before January 1, 1978. In addition, LAL would not apply to governmentally subsidized low-income housing if (*a*) before January 1, 1979, the taxpayer acquires a subsidy commitment under section 8 of the United States Housing Act of 1937 (or a comparable State or local subsidy commitment) and if (*b*) construction begins before January 1, 1981.

2. Farm operations

Accelerated deductions attributable to farm operations would be deferred in a "deferred deduction account" to a later year to the extent that the deductions exceed the taxpayer's net related income from farm operations. Net related income is gross income from farm operations less the "ordinary deductions" attributable to farm operations (deductions other than the accelerated deductions). The limitation would not apply to true economic losses which would continue to be deductible currently.

The accelerated deductions which would be limited as indicated above generally include: (1) preproductive period expenses attributable to crops, animals, trees (or any other property having a crop or yield) but shall not apply to taxes and interest, to any amount incurred on account of certain casualties, to grain, oil seed, fiber, pasture, tobacco, silage, and forage crops (including expenses of planting, seeding, residue processing, fallowing, plowing, or any other soil preparation), and livestock other than poultry; (2) prepaid feed, seed, fertilizer and similar farm supply expenses other than amounts paid for supplies which are on hand on account of certain casualties or amounts paid for feed which is on hand at the close of the taxable year if the taxpayer, on the average, produces more than 50 percent (by volume) of the feed consumed by such taxpayer's livestock; and (3) accelerated depreciation of livestock (or any other property having a crop or yield) after they have begun to be productive in the taxpayer's business. The exclusion from LAL of the preproductive period expenses of grain, oil seed, fiber, pasture, tobacco, silage, and forage crops and livestock other than poultry would not apply to farming syndicates. Also, farming syndicates would not have the benefit of the exclusion from LAL of prepaid feed expenses for taxpayers who grow more than 50 percent of their feed.

In general, a taxpayer could aggregate all farm operations in applying LAL. However, LAL would apply separately for each farm interest in the case of each farming syndicate or similar offering.

Losses attributable to accelerated deductions from farm operations may be used to offset up to $20,000 of nonfarm income. However, if a taxpayer has nonfarm income in excess of $20,000, the amount of artificial farm loss allowable as a current deduction from nonfarm income would be reduced from $20,000, on a dollar-for-dollar basis, for each dollar of nonfarm income in excess of $20,000. Thus, no artificial farm losses could be taken as deductions currently by taxpayers who have nonfarm income of $40,000 or more. Farm income would include income from processing where a farmer processes his farm products.

These LAL rules would apply to individuals, estates and trusts, and corporations which are excepted from the provision requiring certain farm corporations to use the accrual method of accounting for their farm operations. However, LAL would not apply to any taxpayers who use the accrual method of accounting and who capitalize their preproductive expenses.

LAL would apply to accelerated deductions paid or incurred after December 31, 1975, in taxable years ending after such date, including prepaid supplies purchased, preproductive expenses paid or incurred and accelerated depreciation incurred after that time with respect to existing farm operations. However, LAL would not apply to that portion of a grove, orchard, or vineyard planted before September 11, 1975.

3. Oil and gas

LAL would apply to intangible drilling and development costs on developmental oil and gas wells on a property-by-property basis. As a result, these deductions could not be taken in any year to the extent they exceed the net related income derived in that year from the operation of the same property. The amount of the related income (against which the intangible drilling costs could be deducted) would be reduced by the amount of any percentage depletion and dry hole deductions taken with respect to that income. Any excess deductions would be placed in a "deferred deduction account" until such time as the taxpayer has income from that property. If not previously deducted, expenses attributable to a dry hole would be deductible in full in the year in which the dry hole was completed.

LAL would not apply to intangible drilling and development costs incurred in connection with exploratory wells. An exploratory well, for these purposes, includes any well which is located at least 2 miles from a producing well, and any well which is within the 2-mile limit if a measurement of the bottom hole pressure indicates that the well taps a new, deeper reservoir. A well could also be treated as an exploratory well if the taxpayer can establish to the satisfaction of the IRS that, under all the facts and circumstances, the well in question has tapped a new reservoir from which there has been no production in the past. In addition LAL would not apply to water injection wells.

LAL would apply with respect to costs paid or incurred after December 31, 1975.

4. Movies and similar property

LAL would apply to motion picture films and similar property on a property-by-property basis. The accelerated deductions for motion picture films and similar productions would not be deducted currently to the extent they exceed the taxpayer's income from the film. The accelerated deductions to which LAL would apply include depreciation or amortization and amounts attributable to producing, distributing or displaying a motion picture film or video tape. The inclusion of depreciation as an accelerated deduction means that LAL would apply to the "film purchase" shelter in which a limited partnership is formed to purchase a film and the partners claim a substantial depreciation deduction in the earlier years. Production costs would be included as an accelerated deduction subject to LAL to deal with the problem of the "production company" shelter (in which a limited partnership is formed to produce a motion picture and deducts the costs of production as they are paid).

Costs and expenses which may not be deducted currently would be accumulated in a "deferred deduction account" and would be deductible when the taxpayer received income from the film or similar property. The deferred deduction account would terminate at the earlier of (*a*) the close of the first taxable year following any taxable year by the close of which 95 percent or more of the income forecast for the film has been received (this would not operate to make the deduction available sooner than the second taxable year after the film is placed in service) or (*b*) the close of the seventh taxable year following the year in which the film is placed in service.

In the case of deductions for depreciation, LAL would apply to all films except those with respect to which the principal production began before September 11, 1975, for which a binding contract for the purchase of the film was also executed before that date. In the case of deductions attributable to production, distribution or displaying costs, LAL would apply to all films except those with respect to which the principal production began before September 11, 1975. However, LAL would not apply to deductions attributable to producing a film the principal photography of which began on or before December 31, 1975 if (*a*) on September 10, 1975, there was an agreement with the director or a principal motion picture star, or on September 10, 1975, not less than the lower of $100,000 or 10 percent of the estimated production costs had been expended (or committed) and if (*b*) production takes place in the United States. This transition rule applies only to taxpayers who held their interests on December 31, 1975.

5. Equipment leasing

A limitation on artificial losses (LAL) would apply to equipment leasing on a property-by-property basis. LAL would apply to both "net lease" financing transactions and to "operating" leases. The accelerated deductions attributable to an equipment lease would be deferred to a later taxable year to the extent these deductions exceed the taxpayer's net related income from that property. Net related income from a leased property is gross income from the property less the "ordinary deductions" attributable to that property (deductions other than the accelerated deductions). The limitation would not apply to true economic losses which would continue to be deductible currently.

The accelerated deductions to be taken into account under LAL for equipment leasing would be the deductions claimed for accelerated depreciation and amortization to the extent these deductions exceed those allowable under the straight line depreciation method. The optional 20-percent variance in useful lives, authorized under the ADR rules, would not be allowed for purpose of computing straight-line depreciation. This definition reflects the decision to consider the use of shortened depreciable lives for leased equipment, under the Asset Depreciation Range rule, as a facet of the accelerated deductions. Bonus or additional first-year depreciation under Code section 179 is also considered to be a part of the accelerated deductions to the extent it has been allowed as a deduction by an investor for a particular taxable year.

In general, LAL would apply to amounts paid or incurred after September 10, 1975. However, LAL would not apply to leases entered into before September 11, 1975, with respect to taxpayers who held their interests in the property (i) on September 11, 1975, or (ii) in the case of property placed in service before January 1, 1976, on December 31, 1975. LAL would also not apply to leases where the property was ordered by the lessor or the lessee before March 11, 1975, and such property is placed in service before January 1, 1976, with respect to taxpayers who held their interests in the property on December 31, 1975. In addition, LAL would not apply to leases where the lessor is a partnership formed before September 11, 1975, for the purpose of acquiring and leasing personal property, if the property was ordered by the lessee before September 11, 1975, and the property is placed in service before January 1, 1976. This transition rule would apply only with respect to taxpayers who held their interests in the property on December 31, 1975.

6. Sports franchises

In the case of sports franchises, the amount that would be subject to LAL would be the amount paid by the buyer for the purchase of a sports franchise which is allocated to player contracts less the sum of the adjusted basis of the player contracts in the hands of the seller and any gain recognized by the seller as ordinary income with respect to the player contracts. The portion of this amount otherwise allowable as a depreciation deduction for a year would be placed in a "deferred deduction account" to the extent that the deduction exceeds the taxpayer's net related income from the sports franchise for that year. Amounts placed in the deferred deduction account would be allowed as a deduction in later years to the extent that income from the sports franchise exceeds deductions in those later years.

This provision would apply only to sports franchises established or transferred after November 4, 1975, except for sports franchises established or transferred pursuant to a binding contract in existence on such date.

12. HOUSE BILL—OTHER TAX SHELTER PROVISIONS

The House-passed bill includes a number of provisions to deal with other aspects of tax shelters. These are briefly described below.

1. Recapture of depreciation on real property

Under the House bill (sec. 201), in the case of residential real estate, all depreciation in excess of straight line depreciation would be completely recaptured to the extent of any gain realized at the time of the sale of such property. (This rule presently applies in the case of nonresidential property). In the case of low-income housing which is subsidized under Federal, State, or local law, the depreciation in excess of straight line to be recaptured would be reduced by one percentage point for each full month that the property is held beyond 100 months (8⅓ years). Thus, there would be no recapture of the low-income housing is held 16⅔ years. In the event of foreclosure, the percentage reduction would cease at the commencement of foreclosure proceedings.

These provisions would apply for taxable years ending after December 31, 1975 (regardless of the date the property was constructed). The foreclosure rule would apply to proceedings which begin after December 31, 1975.

2. Gain from dispositions of interest in oil and gas property

Under the House bill (sec. 202), any gain on the disposition of an interest in oil or gas properties (or an interest in an oil and gas venture) would be treated as ordinary income to the extent of the excess of the intangible drilling deductions taken with respect to those properties over the deductions that would have been allowed had the expenses been capitalized. This recapture rule is similar to the recapture rule which already applies to depreciation to prevent the conversion of ordinary income into capital gain.

These rules would apply with respect to costs paid or incurred after December 31, 1975, in taxable years ending after such date.

3. Farm excess deductions account

Under the House bill (sec. 203), because farm losses were included in the limitation on artificial losses (LAL), no additions would be made to the farm excess deduction account for any taxable year beginning after December 31, 1975.

4. Method of accounting for corporations engaged in farming

Under the House bill (sec. 204), corporations engaged in farm operations, other than subchapter S corporations and family corporations, would be required for tax purposes to use accrual and inventory accounting methods and capitalize certain preproductive period expenses for their farm operations. A family corporation for this purpose would be defined as one in which at least 66⅔ percent of the voting stock and 66⅔ percent of the total stock in a corporation owned by a single family, including brothers and sisters, spouses, ancestors, and lineal descendants, an estate of any of these family members and trusts for the benefit of such family members. For purposes of the family corporation rule, two families would be treated as a single family in the case of existing holdings if certain conditions are satisfied and, in the case of certain existing holdings stock would be treated as held by the family if it is held by an employee of the corporation, by a member of the family of such employee or by a qualified trust for the benefit of employees. A corporation which elects the exception under this provision would be subject to the LAL rules on farm losses.

This provision would apply to taxable years beginning after December 31, 1975. However, a corporation would be allowed 10 years to spread the accounting adjustments required by this change in method.

5. Treatment of prepaid interest

Under the House bill (sec. 205), taxpayers using the cash method of accounting would be permitted to deduct prepayment of interest only in the period to which it relates under an accrual method of accounting. Points (that is additional interest charges which are usually paid when the loan is closed and which are generally in lieu of a higher interest rate) would be required to be deducted ratably over the term of the loan, except in the case of a mortgage secured by the taxpayer's principal residence. In addition, the prepayment of interest rule would apply to any prepayment involved in a wraparound mortgage.

These provisions would apply to any prepayment of interest after September 16, 1975, in taxable years ending after such date. However, this provision would not apply to amounts paid before January 1, 1976, pursuant to a binding contract or written loan commitment in existence on September 16, 1975 (and at all times thereafter) which required prepayment of interest by the taxpayer.

6. Limitation on nonbusiness interest deduction

Under the House bill (sec. 206), a limitation of $12,000 a year would be imposed on the amount of nonbusiness interest (including investment interest) that an individual can claim as a deduction.

In the case of a loan for investment purposes, interest on the loan would be deductible to the extent of the investment income, in addition to the $12,000 allowable as a deduction under the general rule. Deductions for investment interest which cannot be utilized (due to the limitation described above) would be available as carryforwards and deductible in future years to the extent of related investment income in those years. Interest on borrowings incurred in connection with a taxpayer's trade or business would not be subject to these rules and would continue to be deductible as under present law. These rules would not apply to interest on installment payments of the estate tax.

These rules would apply to taxable years beginning after December 31, 1975. However, these rules would not apply to interest incurred before September 11, 1975 or interest incurred after September 11, 1975 pursuant to a written contract or commitment which on September 11, 1975 and at all times thereafter is binding on the taxpayer (however, the limitation of section 163(d) of the Internal Revenue Code would continue to apply as under present law).

7. Limitation of loss with respect to motion picture films or livestock or certain crops to the amount for which the taxpayer is at risk

Under the House bill (sec. 207), to deal with the problem of leverage, a limitation would be imposed on the deduction of losses in the case of motion picture films and similar productions, livestock other than poultry and certain crops including grain, oil seed, fiber, pasture, tobacco, silage, or forage crops. The deduction of losses would be limited to the amount for which the taxpayer is "at risk", excluding all nonrecourse loans. This proposal would affect the leverage factor which is present in the film purchase shelter, the production company shelter and certain livestock and crop shelters.

In general, this provision would apply to amounts paid or incurred after September 10, 1975, in taxable years ending after such date. However, this provision would not apply to a film or video tape if (*a*) the principal production began on or before September 10, 1975 or (*b*) on September 10, 1975, there was a binding agreement providing for nonrecourse financing for the film in question. In addition, LAL would not apply to losses attributable to producing a film the principal photography of which began on or before December 31, 1975 if (*a*) on September 10, 1975, there was an agreement with the director or a principal motion picture star, or on September 10, 1975 not less than the lower of $100,000 or 10 percent of the estimated production costs had been expended or committed and if (*b*) production takes place in the United States. This transition rule would only apply with respect to taxpayers who held their interests on December 31, 1975.

8. Deduction for intangible drilling and development costs allowable only to taxpayers at risk

To deal with the problem of leverage, the House bill (sec. 208) limits the deduction for intangible drilling and development costs attributable to a property to the amount for which the taxpayer is "at risk" with respect to that property. Thus, a taxpayer would be allowed a deduction only to the extent of his own equity investment in the partnership. The taxpayer would not be allowed to deduct expenses paid out of borrowed funds, unless the taxpayer had some personal liability with respect to those borrowings.

This provision would apply to amounts paid or incurred after December 31, 1975, in taxable years ending after such date.

9. Player contracts in the case of sports enterprises

Allocation of purchase price to player contracts.—Under the House bill (sec. 209), in the case of sports enterprises, the portion of the amount paid to purchase a sports team or group of assets which would be allocable to player contracts or sports enterprises must be specified. The provision would have a presumption that not more than 50 percent of the purchase price could be allocated by the buyer to players' contracts unless the buyer can establish under the facts and circumstances of the case that the players' contracts involved do have a value in excess of 50 percent of the purchase price. In addition, the amount allocable to player contracts by a purchaser could not in any event exceed the amount of the sales price allocated to these contracts by the seller.

This provision would apply to franchises sold or exchanged after December 31, 1975, in taxable years ending after such date.

Recapture of depreciation on player contracts.—In the case of player contracts or sports franchises, the House bill clarifies present law by providing a complete recapture of all depreciation to the extent of any gain involved at the time of the sale of the player contract or of the sports enterprise.

This provision would apply to taxable years beginning after December 31, 1962.

The House bill also provides for the complete recapture of all previously unrecaptured depreciation on the sale of a player contract or a sports franchise. Under this provision, the term previously "unrecaptured depreciation" means the sum of the depreciation allowed or allowable with respect to player contracts after December 31, 1975, and the deductions allowed for losses with respect to player contracts incurred after December 31, 1975, less the aggregate of amounts recaptured as ordinary income with respect to prior dispositions of player contracts. Thus, to the extent of any gain recognized with respect to the sale of player contracts, the amount of the deductions allowed as either depreciation or a loss shall be recaptured as ordinary income even though some or all of the players with respect to whose contracts the deductions were allowed are no longer under contract with the sports franchise.

10. Certain partnership provisions

Under the House bill (sec. 210), several aspects of the partnership tax rules would be revised. First, income or losses would be allocable to a partner only if they are paid or incurred (by the partnership) during the portion of the year in which he is a member of the partnership. In determining whether income, loss or a special item has been paid or incurred prior to a partner's entry into a partnership, the partnership may either allocate ratably on a daily basis or, in effect, separate the partnership year into two (or more) segments and allocate income, loss, or special items in each segment among the persons who were partners during that segment.

Second, income, losses, or items of income, gain, loss, deduction or credit generally must be allocated among the partners (1) in accordance with the permanent method for allocating income, if any, or (2) if there is no such permanent allocation of income, on the basis of the partners' capital. This rule would not apply, however, if the partner receiving the special allocation can establish that there is a business purpose for allocating the loss or item otherwise and no significant tax avoidance results from this allocation.

Third, the amount of additional first-year depreciation that a partnership can pass through to its partners in any taxable year would be limited. A limitation of $2,000 would be imposed on the amount of additional first-year depreciation at the partnership level as well as at the partner level. Thus, a partnership could pass through to each partner his pro rata share of the $2,000 bonus depreciation allowance. An individual then would aggregate all of the additional first-year depreciation from all partnerships in which he was a member, but this aggregate amount for which deductions may be taken may not exceed $2,000 (or $4,000 in the case of a joint return).

Finally, fees for the organization and syndication of a partnership must be capitalized.

These provisions, except to the extent they are declaratory of existing law, would be effective for taxable years of partnerships beginning after December 31, 1975.

11. Scope of waiver of statute of limitations in case of hobby loss elections

Under the House bill (sec. 211), in giving the taxpayer an opportunity to determine whether he has satisfied the rule of present law limiting deductions incurred in an activity which is not engaged in for profit (Code section 183), on the basis of his experience in a 5- or 7-year period, the waiver of the statute of limitations in these cases would be limited so that the waiver does not apply to unrelated items on the taxpayer's return.

In general, this provision would apply to taxable years beginning after December 31, 1969.

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